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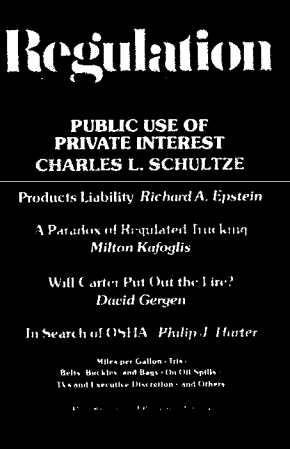
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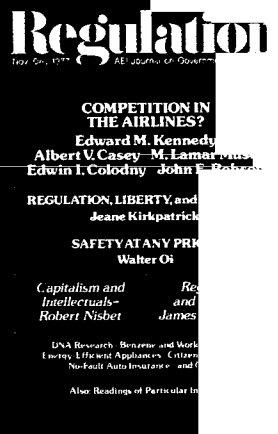

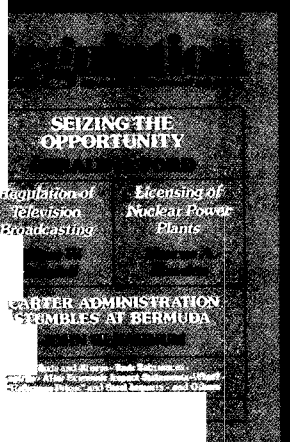
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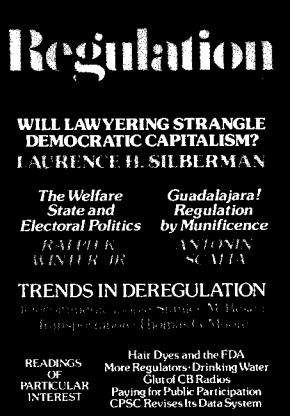

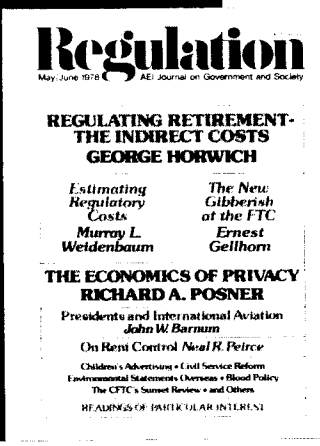
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REGULATION, *July/August 1978, Vol. 2, No. 4. Published bimonthly by the American Enterprise Institute for Public Policy Research.*

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Subscription rates: $12 for one year, $22 for two years (add $2 per year for foreign subscriptions). Single copy price, $2.50. Information on bulk orders or multiple subscriptions available on request. Editorial and business offices: c/o AEI, 1150 17th Street, N.W., Washington, D.C. 20036. Send changes of address and all subscription correspondence to Circulation Department, c/o AEI, same address.

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ISSN 0147-0590

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From the Publisher

A YEAR AGO, we began publishing *Regulation* as a response, in the editor's words, "to the extraordinary growth in the scope and detail of government regulation." It was our belief then—and is now—that the diverse forms of regulation, the range of its support and opposition, and the often confusing nature of its language make this activity difficult to monitor well and impossible to monitor completely. But we have taken large steps toward achieving the difficult in the course of our seven issues to date (this being our seventh) and may even be gaining on the impossible.

We have defined regulation broadly, taking it to mean legislative, judicial, and administrative (even treaty-making) action. Our past year's experience has demonstrated not only the vastness of our subject, but also that there are more ways of approaching it than we had thought. We have, of course, tried to keep our readers abreast of current developments in regulation and of current publications in or about the field. We also have welcomed the continuing debate provided by letters to the editor (and urge our readers to contribute to that debate). But above all, we have been pleased by the breadth and variety of our authors' articles and reports. Some have analyzed theories of regulation or even general theories of political economy that underlie theories of regulation. Some have dealt with one agency or one problem or even one regulatory event. Some have covered the process of regulating and some the process by which regulation comes into being. All, we hope, have appealed to a wide audience.

We have observed that regulation is not restricted to economics and politics, but may be concerned as well with society and culture generally. Moreover, its effects can be felt in all four areas, no matter which of them may have been its original concern. As an example, consider the *Bakke* decision—which, indeed, we will be considering extensively in our September/October 1978 issue.

Regulation enters its second year at a time of considerable ferment in the regulatory field. On the one hand, much headway has been made—certainly on the intellectual front and, to a lesser extent, on the practical front—in trying to improve the ways in which government approaches regulatory activity. For instance, we note with delight a decrease in the number of pages in the *Federal Register* for the first half of the year. Yet that decrease still leaves us with 28,804 pages. Regulations continue to pour out of federal agencies at overwhelming rates.

So, as we celebrate the first anniversary of *Regulation*, we keep well in mind the adage of Satchel Paige: "Don't look back—something may be gaining on you."

William J. Baroody, Jr.

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

The Guadalajara Clause

TO THE EDITOR:

Antonin Scalia's "Guadalajara! A Case Study in Regulation by Munificence" in your March/April issue hits the nail on the head. I was assistant secretary for health, Department of Health, Education, and Welfare in 1976, and I recall how surprised we were when the "Guadalajara Clause" appeared in the version of the Health Professions Assistance Act that emerged from the House-Senate conference. I learned that the provision had originated on the House side and had then survived the conference committee because of House enthusiasm and Senate indifference. The Ford administration had not been consulted. I was so concerned about the provision that I immediately discussed it with then Secretary David Mathews. We had about ten days in which to consider the bill in its entirety and to advise President Ford about signature or veto. Because three years had passed without appropriate legislative authority for the programs on health professions education and because the bill did have some good features, the inclination to get a bill into law was strong. We decided to consult the medical schools through the Association of American Medical Colleges—which reported, I recall, that about 70 percent of its members favored accepting the bill. It should be clear, however, that most people did not have time to think the issue through. And the longing for a known dimension for capitation funds was great.

The contention expressed in the conference committee report—that "federal policy . . . is intended to apply to all schools"—is the concept that most needs reexamination. Why, for example, should all medical schools be required—as they are under the capitation funding condition of the 1976 law—to allocate 50 percent of their residency positions to three primary-care specialties by the academic year 1980–81? The implication is that all schools have to do the same thing in the same way in order to contribute properly to the attainment of national goals. This issue, as pointed out by Professor Scalia, hits at the fundamental precepts of the American educational system.

Theodore Cooper, M.D.,
Cornell University

Telecommunications

TO THE EDITOR:

Stanley Besen has done a commendable job in summarizing recent changes in telecommunications regulation and the prospects for further deregulation ("Deregulating Telecommunications," *Regulation*, March/April). In the few pages allotted him, Besen understandably had to gloss over many issues to which he might have given much greater emphasis in a longer article. Unfortunately, I believe that readers unfamiliar with the complicated world of common-carrier technology might be misled by his article into believing that continued rate regulation of the multitude of services offered by AT&T and its rivals is both feasible and desirable.

It was inevitable that the FCC would have to open up the interstate communications markets to new competitors. With new technology developing in microwave transmission and satellite distribution and with AT&T locked into depreciating an increasingly obsolete plant over a very long accounting life, new competitors would be knocking at the door with a new generation of equipment that Bell would be unwilling or unable to offer. Specialized carriers of microwave signals offered digital service for business data communications at a time when Bell's plant was incapable of providing the service. Increasingly sophisticated terminal equipment grew out of the electronics revolution, threatening to displace the old handsets, terminals, and PBXs offered by Bell. The Federal Communications Commission could hardly pursue "the public interest" by discouraging the use of such technology.

Yet when the commission began to offer limited entry into interstate transmission and terminal equipment markets, it faced several problems only one of which Besen addresses.

First, it faced the problem of ascertaining the appropriate price of each interstate service. In the past, it had simply examined AT&T's overall rate of return, allowing the company to dictate the rate structure. But once it opened up part of AT&T's world to competition, issues of rate structure became important, not simply for reasons of economic efficiency but because of competitors' howls.

The rate structure issues emerged in AT&T's responses to competition in everything from *Telpak* to high-low pricing, WATS service, and digital data service. In most of these cases, the commission took a dim view of that company's aggressive competitive responses. As a result (as Besen observes), the commission refused to allow it to base its charges on estimated incremental costs of competitive services, requiring it instead to charge on the basis of "fully allocated" costs. The reason for this decision, I believe, was simply distrust of how AT&T's management assessed the company's *future* incremental costs of service. The commission wanted something tangible to base the rates upon and it wanted the costs to add up to AT&T's total costs. It therefore asked management to allocate all *historical* costs in a fully allocated cost analysis. While deviations from the actual historical outlays were utilized in various versions of fully allocated cost calculations submitted by the company, management was not permitted to base rates on prospective incremental costs (the economically efficient choice).

In the rapidly changing world of electronics and communications technology, to tie AT&T to pricing rules that depend upon historical, imbedded costs is to require it to price inefficiently. Moreover, if entry is permitted while the existing firm is constrained to historical-cost

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pricing, the existing firm must operate at an enormous disadvantage if more than one rate obtains for the same service in the same market.

The explosion of new technology has only begun to be felt in AT&T's markets, and entry has thus far been limited to some of the less exciting areas. The major threat to AT&T at this moment is not a service based upon a new, exotic technology, but one which exploits the mistakes of regulation. "Execunet," a long-distance business service, has simply taken advantage of (1) the poor methodology used by the FCC and state commissions in "separating" interstate and intrastate costs and (2) the absence of time-sensitive pricing for local exchange service in the various state jurisdictions. But this is not the major long-term threat facing AT&T.

What we will see in the near future is an explosion of new services based upon new technologies. If the commission persists in requiring AT&T to meet this prospective competition on the basis of rates calculated by historical, embedded (average) costs, it will be giving new competitors an unfair advantage since AT&T will be required to charge prices high enough to cover the costs of using an old technology. Yet the commission can never know AT&T's true incremental costs. In fact, it is now discovering that it cannot even ascertain the existing embedded costs for each service, whatever the accounting method used.

The FCC is now faced with the task of drawing boundaries between potentially competitive markets and "natural monopolies," allowing entry into the former but not the latter. Besen apparently believes that such a distinction is possible. I am not convinced. Where does "local distribution" begin and end? Is my home rooftop satellite antenna to be considered part of an interstate-transmission system or part of a local distribution system? What if my next-door neighbor has the same equipment and uses it to communicate with me? What is my CB radio? What if, say, Carterfone discovers a method of allowing me to tie in to the satellite system through my CB radio? I doubt that there is a true "natural monopoly" left in communications, only monopolies protected by regulation. Why not ask the commission simply to open up the world to competition? But then who would repay AT&T stockholders if deregulation led us to discover that their assets are overvalued because of decades of slow depreciation required by the commission's rate-setting policy?

In short, I think that the opening of communications markets to competition has created a much more difficult situation for the FCC than Besen portrays. It can never know the costs of providing each of a multitude of services that share common facilities. It must, therefore, set prices on the basis of informed guesses and the pleadings of competitors. How can any of us argue that this type of regulation serves the "public interest"?

Robert Crandall,
Brookings Institution

STANLEY BESEN responds:

Robert Crandall's letter highlights the dilemma faced by the FCC as it attempted to deal with "competition" in the telephone industry. The commission had three broad alternatives. First, it could have argued that the public interest would best be served by maintaining, and perhaps extending, the legal monopolies possessed by the existing carriers. Second, it could have thrown open the entire telecommunications market to unfettered competition between the incumbents and the would-be entrants. This would have entailed giving AT&T and other telephone companies complete freedom to set rates. The FCC chose neither of these alternatives but rather a third: it allowed "competitors" to enter certain selected markets—those in which the commission had concluded that natural monopoly elements were relatively unimportant or that rapid technological change would best be promoted by a multitude of firms—and it limited the competitive responses of the existing carriers.

This policy has created a fundamental problem. As Crandall notes, it places a heavy burden on the commission to determine into which markets entry should be permitted and what prices AT&T and others can charge. This burden may be too much for the commission to bear. Moreover, as I argued in my article, the FCC has adopted a criterion for judging the competitive response—namely, existing carriers must price so as to cover "fully distributed costs"—that may lead to a worse outcome than if entry had not been permitted. (One of the reasons given for using this criterion is that it is easier to monitor than one based on the more appropriate incremental cost concept.)

I take the thrust of Crandall's letter to be that "full and fair" competition (which the FCC says it seeks to promote) should involve limitations neither on entry nor on the permitted responses of the existing carriers. The alternative I suggested was a possible restructuring of the industry so that at least some parts of it could be left unregulated. But neither of us is likely to get his wish, and I suspect that each of us would prefer the other's first choice to the "regulated competition" the commission seems to prefer.

Welfare and Voting

TO THE EDITOR:

American conservatism has, to the surprise of many of us, recently come forward with a body of argument that is thoughtful and challenging, and has begun to rebuild a position in the debate over public policy issues that has been missing for over a generation. Professor Ralph K. Winter's lively article ("The Welfare State and Electoral Politics") in the March/April issue of *Regulation* embodies some of the strengths of this position, but also illustrates some foibles that could prove to be its undoing.

John Stuart Mill once wrote that the prayer of every serious liberal should be, "Lord, enlighten thou our enemies. . . . We are in danger from their folly, not from their wisdom. . . ." Perhaps those of us who have suffered from the embarrassments of the New Left can offer some worthwhile advice to those whose conservatism is tempted toward habits of mind that are strikingly reminiscent of the presumptions and ideo-logic that we battled for so long at the Left-of-Center.

Professor Winter, in the vein of the late-lamented new populists of the Democratic party, sees a sullen protest against big government and high taxes in the decline of voter participation in our national elections. He concludes that we are caught in a "drift away from democracy" which can only be ended by strapping government into a Procrustean bed of fixed taxing and spending limitations. (Procrustes, I am told, was a Greek bandit who placed his victims on a bed and chopped off whatever—head, arms, feet—stuck out over the edges. This treatment did affect the victims' size, but hardly at the places that are most likely to grow to flab.)

There have been some careful studies of our nonvoters (see, for example, the work of Jack Citrin and

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Warren E. and Arthur H. Miller), and they do not provide any support for Professor Winter's assumption that these citizens are disgusted by their inability to impose limits on the size and spending of government. The nonvoter is not always the alienated citizen, but may just as well be the satisfied citizen, who assumes that elections bring little change and who therefore does not trouble to go to the polls. And, among those nonvoters who could be described as frustrated to the point of cynicism, such frustrations may be the result of many causes other than big government and big spending. Indeed, they may arise from the opinion that government is not doing enough or spending enough to make much difference in their affairs.

Nor is it precisely correct to assert, as Professor Winter does, that "most voters want less government, less taxes, less inflation, along with the maintenance of a decent level of support for the genuinely poor." The problem seems to be that while voters do want less inflation and less taxes, they also want to keep many costly government services, and even to expand government in a number of areas—job creation, health security, drug abuse, crime control, education, and national defense—that will inevitably require a large bureaucracy and higher taxes. (Professor Everett Carll Ladd, Jr., provided a good summary of these public desires in last October's *Fortune* magazine and keeps a running account of them in AEI's *Public Opinion*.) The voters want a great deal from government, but they don't want to pay a high price for it, or lose their liberty to it. Some commentators seem to believe that this is deranged thinking. But is it really so abnormal? Who doesn't want something for nothing?

Professor Winter comes closer to a vulnerable target in his complaints against those who, while supposedly helping the poor, have really been helping themselves, often at a handsome cost to the taxpayer. He is also on sound ground in his criticism of legislative logrolling: spreading the benefits of a program to groups whose needs are not at all pressing in order to win legislative support for it. But his solution for these abuses leans more toward an attack upon government than toward an attack upon the abuses of government.

His despair over the normal processes which govern taxing and spending leads Professor Winter toward the schemes of the tax revolt movement, which seeks to impose inflexible limits on the taxing powers of government. (These seem to be for the New Right what such things as the congressional War Powers Act and the cutoff of aid to the South Vietnamese were for the peace movement.) There are a number of strong economic arguments against this approach. But the political arguments are equally important and fill out the comparison between the New Conservatives and the New Left—a movement which had a similar mistrust of the capacities of representative government.

There are good grounds for assuming that the voters want efficient delivery of government services, dislike bureaucratic intrusiveness and red tape, prefer economic growth to welfarism as a means of ending poverty, and resent the "poverticians" and purveyors who have captured such a high proportion of the money intended to alleviate real poverty. It is equally true that today these sentiments are not very effectively brought to bear in the give-and-take of representative government. But an attack upon government itself by the New Conservatives—a revival of the old hatred of the New Deal will not, even if it should partially succeed, root out the ideologues, malfeasants, and incompetents who are responsible for government abuses. Moreover, there are those in liberal and labor circles who, while they strongly favor some aspects of big government, are also dismayed by its excesses. If, rather than opting out in disgust to attack the "establishment," the New Conservatives mounted a patient and vigorous attack on these abuses within the legislative system, they might not achieve their libertarian utopia, but they would certainly contribute a great deal to the effectiveness and vitality of modern government.

If they indulge the illusions and the strategy suggested by Professor Winter, they may very well discredit themselves and drive many of those who are discovering some merits in their critique back toward a reluctant alliance with those who favor big government for big government's sake—and for their own.

Penn Kemble,
American Enterprise Institute

RALPH WINTER responds:

One could hardly argue with Mr. Kemble's proposition that we avoid Draconian measures and focus on specific abuses of the welfare state if he accompanied his comments with realistic proposals on how that might be accomplished. The burden of my argument, after all, was that specific abuses are very unlikely to be eliminated on any widespread scale, given the present nature of our electoral politics. Voters will not vote to eliminate "abuses" which benefit them unless they are assured in advance that enough "abuses" which benefit others will also be eliminated so as to bring about a net gain in their welfare through the reduction of taxes and of bureaucratic control. I argued that candidate-versus-candidate politics does not realistically offer this kind of option to the voters, since such a result depends upon the behavior of numerous candidates representing other constituents. Voters thus take an "after you" approach and insist that they retain and increase their benefits in the absence of a general reduction of government services. As a consequence, the growth of government continues even though voters would prefer otherwise.

Mr. Kemble does not address this argument but focuses rather on one of a number of remedies I mention and rightly criticizes it as drastic. He does not, however, suggest realistic and less drastic alternatives to that or even to my more modest proposals such as indexing the progressive income tax. The spiraling size of government and the inflation that accompanies it are themselves drastic, and something more than criticism of "abuses" of the welfare state is necessary to stop it.

So far as his observation that voter apathy has many sources is concerned, again I do not quarrel with his general proposition. Nevertheless, I remain convinced that my analysis is a valid partial explanation of voter indifference. In no way does my analysis require that voters consciously perceive that the inability of candidates to make credible promises to reduce taxes and government controls is the reason for their nonparticipation. I would not expect, therefore, that public opinion research would necessarily conclude that this inability is a major source of voter indifference. I would rely rather on the fact that, in the most recent primaries, the "after you" candidate-versus-candidate politics produced yawns among voters everywhere, while the "all together" approach of Proposition 13 (however poorly drafted or misdirected that proposition may have been) generated the only voter interest. ■

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Perspectives
on current developments

OSHA and the Fourth Amendment

The recent Supreme Court decision in *Marshall* v. *Barlow* offers businesses a Fourth Amendment shield against warrantless inspections by the Occupational Safety and Health Administration. Although hailed by some business spokesmen as a great victory, the decision is unlikely to have much effect on OSHA enforcement.

At issue in *Barlow* was the constitutionality of Section 8(a) of the Occupational Safety and Health Act that empowers agents of the secretary of labor to inspect an employer's work area for safety hazards and other violations of OSHA rules without getting a warrant. Seeking injunctive relief against warrantless searches, Barlow's, Inc., argued that Section 8(a) contravened the Fourth Amendment's protection against unreasonable searches and seizures. By a 5–3 vote, the Supreme Court agreed. It reaffirmed its earlier rulings that warrantless searches are presumptively suspect under the Fourth Amendment, that the presumption shields places of business as well as residence, and that Fourth Amendment protections apply to both civil and criminal investigations.

In presenting its case, the government had urged that two exceptions to the warrant requirement kept Section 8(a) from contravening the Fourth Amendment. The first exception strips warrant protection from heavily regulated industries (liquor and firearms, for example) because there can be no reasonable expectation of privacy from government intrusion in their case. Its rationale is that persons going into business in such industries in effect consent to statutory curtailments of privacy rights. The second exception allows warrantless searches that are necessary to effective enforcement of regulatory statutes and do not seriously threaten privacy rights. Warrantless OSHA inspections were necessary, the government contended, because an employer might hide or remedy safety defects during the time between an inspector's abortive request to search a plant and the procurement of a warrant.

The Court held that neither exception applied in the case. The first failed because the targets of Section 8(a) are not limited to heavily regulated industries. Noting that this section reaches all businesses having an effect on interstate commerce, the Court asserted that it would be fanciful to infer a voluntary consent to warrantless inspections by the millions of employers subject to OSHA. The second exception, which is founded on administrative necessity, failed on the grounds that warrants may be issued ex parte and executed without delay or prior notice, thereby preserving the advantage of surprise. Moreover, the Court noted, OSHA's regulations, which require inspectors to get court orders if refused entry to business premises, belie the claim that warrants would jeopardize the effectiveness of the existing inspection system. Accordingly, the Court held that the enforcement concerns voiced by the government were insufficient to brush aside the general Fourth Amendment requirement of a warrant to justify searches.

In reaching this conclusion, however, the Court largely vitiated its significance by refusing to require that OSHA warrants be granted only if there is probable cause for believing a violation exists on an employer's premises. The Court stated:

> A warrant showing that a specific business has been chosen for an OSHA search on the basis of a general administrative plan for the enforcement of the Act derived from neutral sources such as, for example, dispersion of employees in various types of industries across a given area, and the desired frequency of searches in any of the lesser divisions of the area, would protect an employer's Fourth Amendment rights.

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Thus, warrants will be granted in cases where reasonable legislative or administrative standards for inspection are satisfied.

Little change should be expected in the frequency and effectiveness of OSHA inspections in the wake of the *Barlow* decision. First, OSHA regulations apply to approximately 5 million businesses and are enforced by only 1,300 inspectors. Ordinary principles of good management would require deploying these inspectors under a plan that (according to *Barlow*) will justify issuance of a warrant to inspect particular businesses. OSHA's managers apparently had used such plans prior to *Barlow*, because Barlow's, Inc., was chosen for inspection on the basis of the accident experience and number of employees exposed in its industry. It is thus unlikely that OSHA will be compelled to alter its enforcement strategies in order to obtain inspection warrants. Indeed, *Barlow* left open the question whether judicial orders for inspections routinely sought under the secretary's existing regulations when employers refuse entry are the functional equivalent of warrants and thus satisfy the Fourth Amendment.

Second, when OSHA's inspectors conduct criminal investigations with the assistance of a U.S. attorney, they may obtain warrants by telephone pursuant to Rule 41(c)(2) of the Federal Rules of Criminal Procedure. (If the purpose of an OSHA search is to obtain evidence of crime rather than civil infractions, probable cause to believe criminal conduct has occurred must be shown to justify a warrant.) This procedure will minimize any dissipation of criminal enforcement energies.

Third, *Barlow* erects no barrier to surprise inspections because warrants may be issued ex parte and summarily executed without prior notice to an employer.

The only important safeguard *Barlow* offers employers is protection against inspections conducted in bad faith or for purposes of harassment. These will be forestalled by the requirement that a warrant application both state the purpose of the intended search and show that the target was chosen on the basis of a plan containing specific and neutral criteria.

Whether *Barlow* foreshadows judicial condemnation of warrantless searches authorized under other regulatory statutes (such as the Mine Safety Act and the Air Pollution Control Act) is uncertain. The Court expressly reserved decision on these questions, noting that the specific enforcement needs and privacy guarantees of each statute would govern the constitutional determination in each instance. However, the Court's readiness to countenance the issuance of warrants on the basis of a relaxed showing of cause would appear to minimize the significance of curtailing warrantless searches by administrative agencies.

The Railroads' "Yo-Yo" Provision Expires

When Congress enacted the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act), it intended, among other things, a major change in the way railroad rates are set. The plan was to let the marketplace determine rail rates in areas with effective competition. To this end, the act contained two key provisions:

(1) The Interstate Commerce Commission could no longer hold any rail rate to be "unjust and unreasonable" (too high or too low) so long as the rate contributed to the "going concern value" of the railroad —*unless* the ICC found that the railroad possessed "market dominance" over the traffic concerned.

(2) Railroads could increase or decrease rates by as much as 7 percent without those rates being suspended by the ICC—*unless*, again, the ICC found that the railroad possessed market dominance.

The latter provision, dubbed the "yo-yo" by its detractors, was viewed by the Congress as an experiment and was therefore scheduled to expire two years after enactment.

In the two years, rate filings under the "yo-yo" provision were inconsequential, despite the fact that many experts had expected the provision to inject considerable price competition into the industry. Why, in the face of these expectations, did it have so little effect? There appear to have been two major reasons.

First, under the 4-R Act, rate changes are still covered by provisions of the Interstate Commerce Act prohibiting discrimination among shippers and commodities. Many shippers simply protested rate increases on those

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grounds, and the time-consuming and costly process of meeting these challenges soon discouraged railroads from filing rates under the "yo-yo." A more important reason was the ICC's way of determining market dominance. The 4-R Act defined market dominance as an "absence of effective competition from other carriers or modes of transportation," and directed the ICC to come up with rules for determining whether, in a given situation, a rail carrier possessed such dominance. Thus, the act gave the commission broad discretion to establish an important determinant of the degree of rate flexibility to be allowed.

When in August 1976 the ICC issued its initial proposal for ways of determining market dominance, there followed a series of pitched verbal battles, with the industry, the Department of Justice, and the Department of Transportation opposing the ICC staff and some shippers. Finally, on October 1, 1976, the ICC announced four conditions that would establish a *rebuttable presumption* of market dominance (that is, if these conditions obtained, the railroad would have to prove it did *not* have market dominance). The conditions were the following: (1) when a railroad's rate exceeds the variable cost of providing the service by 60 percent or more, (2) when the railroad handles 70 percent or more of the traffic to which the rate applies, (3) when a shipper has made a "substantial" investment in ancillary rail equipment or facilities, and (4) when the proposed rate has been discussed in a rail rate-bureau proceeding.

The railroads asked the Court of Appeals for the District of Columbia to review the ICC's decision, arguing (mainly) that it was contrary to congressional intent since its effect would be to limit rather than promote rate flexibility and competition. The appeal was rejected on May 2, 1978. Although the court did ask the ICC to clarify certain aspects of its 60-percent-of-variable-cost standard, it found that the decision was reached through proper procedure and was consistent with the act.

Before that decision, in February 1978, the "yo-yo" provision expired amidst general disinterest. In this there must be a lesson for those who would reform regulation by granting the regulatory agency significant discretion to determine the degree and speed of change.

New Rules against "Redlining"

With considerable fanfare, the Federal Home Loan Bank Board moved in May to strengthen rules designed to prevent discrimination in the lending practices of its member savings and loan associations. Many of the new rules (which were effective July 1, 1978) seem relatively innocuous. But the one designed to end discrimination against entire neighborhoods, a practice known as "redlining," raises difficult questions.

Under the equal opportunity provisions of various civil rights and home financing laws, the FHLBB moved some time ago to prohibit discrimination in lending on the basis of the race, color, religion, sex, or national origin of prospective owners or tenants. Recently, however, savings and loans have been accused of indirectly continuing such discrimination by using loan decisions based on the age and location of the dwelling as a means of denying loans in neighborhoods in racial transition or with large minority populations. The FHLBB's new regulations will stop redlining of this sort by forbidding savings and loans

> —from denying loans or varying loan terms solely on the basis of the age or location of the dwelling, or on the basis of the race, color, religion, sex, or national origin of residents in the vicinity of the dwelling, and
>
> —from using appraisals that are discriminatory in the same way.

The goal of ending redlining is widely supported. The practice exacerbates neighborhood decline by discouraging homeownership and rehabilitation, by reducing the values of the existing dwelling units, and by encouraging a trend toward higher-density rentals. Because racial transition per se is not a cause of urban decline, prohibiting it as a basis for determining whether to make loans could help stabilize residential neighborhoods. The impact of the FHLBB action should be far-reaching, since savings and loans accounted for roughly half of the net increase in residential mortgages during 1977 and since nearly 98 percent of all savings and loans are members of the board.

The issue of discrimination arises in this instance not so much out of prejudice on the part of the lenders as out of the fact that information on the relative security of loans is

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neither perfect nor free. In many cases it may be less costly for the lending institution (and for those who receive mortgages) to have simple rules of thumb that identify dwellings in some locations as "good" risks and those in others as "bad" (and similarly with respect to age). What the FHLBB's regulations do is require that lending institutions look beyond rules of thumb so as not to place undue weight on age and location. While these may be two major factors in a property's present and future market value, the rules limit their significance by clarifying the acceptable locational risk factors, by requiring greater emphasis on the physical characteristics of the dwelling, and by insisting that negative factors associated with the dwelling be clearly documented.

The recent FHLBB action illustrates the difficulty of achieving balance between preserving sound business judgments and eliminating potentially discriminatory practices. In this instance, the key to successful regulation is to write rules that forbid discrimination, while still allowing the lender to determine the security of the loan in a way that is both objective and not overly costly. When the FHLBB proposed the regulations last November, it clearly recognized this problem, stating that

> loan decisions should be based upon the value of the individual structure . . . unless specific neighborhood factors affecting its present or short-range future value (such as current market trends based on actual transactions involving comparable property, or housing abandonment in the immediate vicinity) are clearly established and documented.

The final guidelines have made the rules more rigid by spelling out the criteria—zoning changes and a "significant" number of abandoned homes in the immediate vicinity—that may be legitimately considered as risk factors. Moreover, in certain cases even these criteria may not be used to deny a loan or require more stringent terms.

In view of the constraints on the loan-approval process, there is concern in the industry that savings and loan associations may be forced to make loans in excess of the true market value of the dwellings. This would lead to increased losses in the event of foreclosure (since the dwelling could not be sold for the amount of the loan) and perhaps also to an increased number of foreclosures (since restrictions would have been placed on determining property value). The result would be higher interest rates, inasmuch as increased costs would eventually be passed on to consumers.

This concern is fed by the prospect that the new regulation will open up highly profitable opportunities for unscrupulous realtors in much the same way that HUD's Section 235 interest-subsidy program did in the early 1970s. In that case, a program to stimulate homeownership for lower- and middle-income people was used by some realtors to sell inner city homes at inflated values (and thus with inflated commissions). Banks and savings and loan associations had less incentive to ascertain a property's true value or a borrower's creditworthiness when HUD assumed a large part of the risk by insuring the mortgagee. Similarly, the new regulations might lead to a situation where lenders would provide needed financing even for sales where the property value is inflated—in this case, not for lack of incentive to determine true property values but because they will be unable to act otherwise.

Ultimately, of course, the validity of such fears will depend on the FHLBB's interpretation and enforcement of its own regulations. Eliminating redlining without undesirable side effects is not likely to be easy.

The Valproic Acid Controversy

Epilepsies—symptoms of neurological disorders characterized by seizures—afflict an estimated 2 million Americans. Many of these Americans, plus their physicians and congressmen, are calling for a review of the domestic drug-approval process because of their frustration in the valproic acid case.

Valproic acid is an anticonvulsant drug that has been used in Europe for a decade but was only recently approved by the Food and Drug Administration for marketing in the United States. The benefits of the drug are clear. It prevents several types of seizure, is not a sedative or subject to abuse, causes less severe side effects than many other anticonvulsants, and, perhaps most important, appears to be the

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only drug capable of effectively controlling seizures for a small number of epileptics.

Nevertheless, because the vast majority of epileptics are satisfactorily treated by existing drugs and may be hesitant to try a new one, a relatively small market was envisioned for valproic acid. This, together with rising costs for new drug development and marketing in this country, may explain why it took seven years for the drug's French developer to locate a licensee in the United States. In 1974, the tenth U.S. firm approached, Abbott Laboratories, agreed to pursue development of the drug.

Although valproic acid was already available in ten countries, the FDA required additional clinical (human subject) tests, claiming that only one of the 200-odd foreign studies of valproic acid published since 1967 was fully acceptable. It rejected the others for using controls said to be inadequate or for supplying insufficient raw data to enable the FDA to conduct independent evaluations of safety and effectiveness.

Moreover, even after domestic tests were conducted, the rigorous FDA approval process resulted in further delays. For example, in 1977 a collaborative study on valproic acid's effectiveness by Abbott Laboratories and the National Institute of Neurological Diseases and Stroke was submitted with Abbott's New Drug Application (NDA, an application that must be approved before a drug is marketed). The FDA rejected the study because of a biased test sample and requested further data, despite the fact that its Neurological Drugs Advisory Committee had unanimously recommended approval of the NDA on the basis of available information.

Meanwhile, the Epilepsy Foundation of America charged that the FDA's refusal to approve valproic acid was causing many epileptics to suffer unnecessarily and driving some to smuggle the drug from Mexico. Its publication, *National Spokesman,* was carrying monthly articles on the "intense pressure" being applied to the FDA and Abbott by outspoken parents of epileptic children and broad media coverage. The FDA stood its ground, insisting that until what it judged to be "adequate and well-controlled" studies were supplied by would-be manufacturers, neither cries for congressional investigations, nor reports from independent panels of experts (convened by the Epilepsy Foundation), nor attention from NBC News would "cut any ice." Only after additional research reports were supplied did the FDA finally approve the marketing of valproic acid in February 1978.

The three-year experience with valproic acid is being used to generate support for the Drug Regulation Reform Act (H.R. 11611 and S. 2755), now before the Congress (see *Regulation,* May/June, p. 12). The bill's supporters maintain that a "crescendo of complaints" was needed to push a dilatory regulatory agency into action. They look favorably upon provisions in the bill that would provide for speedier, but *provisional,* approval of particularly promising drugs, and would establish a National Center for Clinical Pharmacology within the Department of Health, Education, and Welfare to develop valuable drugs of little commercial interest to private firms. Yet, other observers praise the "unusually quick approval" of Abbott's NDA and describe the FDA's regulatory process as "working effectively and objectively in the face of strong emotions and partisan pressure." Still others, maintaining that the valproic acid controversy merely highlights the need to reform the whole regulatory approach, would eliminate the proof-of-effectiveness requirement enacted in 1962 and restrict the FDA's role to ensuring that drugs are safe. Each view has its adherents, suggesting that valproic acid will take its place in the formulary for continuing congressional debate on public health issues.

Vermont Yankee Power: Judicial Oversight of Agency Procedures

A recent opinion of the Supreme Court may have far-reaching implications for the fairness and efficiency of the regulatory process. As starkly exemplified by the *Home Box Office* case (discussed in the July/August 1977 issue of *Regulation*), some federal courts, and in particular the U.S. Court of Appeals for the District of Columbia, have felt free to engraft additional requirements upon the rulemaking procedures established by the Administrative Procedure Act. These statutory procedures are, quite simply, to publish the proposed rule in

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the *Federal Register*, to give interested parties the opportunity of making written or (at the agency's discretion) oral comments, to consider such comments before promulgating the final rule, and to set forth a concise statement of the rule's basis and purpose. In *Home Box Office*, as *Regulation's* readers may recall, the Court of Appeals for the District of Columbia sought to add to these procedures *in all cases* the requirement that the agency entertain no off-the-record communications with persons outside the agency concerning the proposed rule. Such a general requirement at least has the virtue of being predictable in its operation. Even more troubling for agency counsel have been those court decisions which do not lay down a general requirement, but which state that the peculiar characteristics of a particular rulemaking proceeding demand a specific additional procedure (for example, cross-examination of witnesses) or, worse still, an unspecified "something more"—a procedural *je ne sais quoi* that the court (in deference to the agency's expertise) declines to identify and the agency must guess at on remand.

Vermont Yankee Nuclear Power Corp. v. *Natural Resources Defense Council*, decided on April 3, 1978, involved the latter sort of decision by the Court of Appeals for the District of Columbia. At issue was a rule adopted by the Nuclear Regulatory Commission dealing with the manner in which the environmental impact of nuclear fuel reprocessing or disposal would be evaluated in power plant licensing proceedings. Challenging the rule, environmentalists complained that they had been denied the procedures of discovery and cross-examination. The court of appeals agreed that the procedures used by the agency were inadequate, though it refused to say wherein:

> We do not presume to intrude on the agency's province by dictating to it which, if any, of [various procedural devices listed earlier, including discovery and cross-examination] . . . it must adopt to flesh out the record. . . . It may be that no combination of the procedures mentioned above will prove adequate, and the agency will be required to develop new procedures. . . . On the other hand, the procedures the agency adopted in this case, if administered in a more sensitive, deliberate manner, might suffice.

The Supreme Court's disposition of the appeal constitutes an emphatic reversal. "Absent constitutional constraints or extremely compelling circumstances," it said, agencies are free to fashion their own procedures as long as the bare minima of the Administrative Procedure Act are met. It characterized the approach of the court of appeals as "Monday morning quarterbacking [which] not only encourages but almost compels the agency to conduct all rulemaking proceedings with the full panoply of procedural devices normally associated only with adjudicatory hearings." The court, it said, should not "stray beyond the judicial province to explore the procedural format or to impose upon the agency its own notion of which procedures are 'best' or most likely to further some vague, undefined public good."

In its *Vermont Yankee* opinion, the Supreme Court also disposed of another case involving reversal of the Nuclear Regulatory Commission by the Court of Appeals for the District of Columbia. The precise issues presented in that case, *Consumers Power Co.* v. *Aeschliman*, are of less general application; suffice it to say that they also (1) pertained to the appeals court's imposition upon the NRC of onerous procedural requirements not clearly set forth in the governing statutes and (2) produced a sharp reversal by the Supreme Court. In fact, the Court's criticism in this part of its opinion is even more acerbic: "To characterize the actions of the Commission as 'arbitrary or capricious' [as the court of appeals had to do in order to meet the statutory standard for reversal] . . . is to deprive those words of any meaning." Also, "This surely is, as respondent Consumers Power claims, 'judicial intervention run riot.'" What is more, "To say that the Court of Appeals' final reason for remanding is insubstantial at best is a gross understatement." Finally, "To . . . nullify [agency action for the reason given by the court of appeals] borders on the Kafkaesque."

The opinion concludes with a passage intimating that the court of appeals may be somewhat "result-oriented" in its approach to judicial review:

> Nuclear energy may some day be a cheap, safe source of power or it may not. But Congress has made a choice to at least try nuclear energy, establishing a reasonable

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> review process in which courts are to play only a limited role. The fundamental policy questions appropriately resolved in Congress and in the state legislatures are *not* subject to reexamination in the federal courts under the guise of judicial review of agency action. . . . [The National Environmental Policy Act] is to ensure a fully informed and well-considered decision, not necessarily a decision the judges of the Court of Appeals or of this Court would have reached had they been members of the decision making agency. Administrative decisions should be set aside . . . only for substantial procedural or substantive reasons as mandated by statute, not simply because the court is unhappy with the result reached.

The Vermont Yankee/Consumers Power opinion may be less important for the precise points of law it resolves than for the general philosophy it displays with regard to the limited role of the courts in the administrative processes. The opinion is an extraordinarily sharp rebuke to the activism of the Court of Appeals for the District of Columbia. Particularly impressive is the fact that the opinion was unanimous. (Justices Powell and Blackmun did not participate in the decision.) To tell the truth, however, the opinion represents an enormous change in the attitude of the Supreme Court itself over the past few years. In a much-cited opinion handed down in 1971, the Court emphasized the need for a "thorough, probing, in-depth review" of administrative action. By contrast, the concluding sentence of the current opinion insists that "a single alleged oversight on a peripheral issue . . . must not be made the basis for overturning a decision properly made after an otherwise exhaustive proceeding."

It is not difficult to predict the reactions of agency lawyers and the public interest bar to the apparent new regime of judicial restraint—elation for the former (suppressed so as not to antagonize the Court of Appeals) and keen disappointment for the latter. But for lawyers representing the regulated industries, the new dispensation may be half-blessing, half-curse. It was, after all, the company lawyers who carefully cultivated the flower of judicial review from the 1920s through the 1950s—as a barrier (they would say) against agency arbitrariness or as an opportunity (others would say) for producing delay and for providing their clients a "second bite at the apple." Only in the 1960s did the flower begin to take on, in their estimation, some of the characteristics of a weed—as drastic revision of court-made doctrines such as standing and ripeness made it increasingly easy for both overly lenient and overly strict regulatory judgments to be challenged, and as public-interest lawyers multiplied to take on that task.

From the standpoint of the general welfare, however, the new direction represented by *Vermont Yankee/Consumers Power* should probably be welcomed. Result-oriented decisions aside, there is much to be said for the view that the recent activism of the courts in the review of administrative action has driven home to the agencies, as nothing else would, their responsibility for designing fair and informative procedures. That being granted, however, the evidence is mounting that the cost of delay—both the primary delay involved in routine appeal to highly receptive courts and the derivative delay caused by super-cautious agency procedures—outweighs the benefits to be derived from continuing case-by-case elaboration of a basic lesson already taught.

The nuclear power plant involved in *Vermont Yankee* is a case in point. Application for a construction permit was filed with the Atomic Energy Commission in the second year of Lyndon Johnson's last term as President and was granted a year later. Application for the second necessary federal permit, an operating license, was filed in the first year of Richard Nixon's first term; an agency decision on that matter was reached in the first year of Nixon's second term; the intra-agency appeal consumed another year; and appeal to the first level of judicial review was begun the year Gerald Ford entered office. Moreover, the Supreme Court's decision (rendered in the second year of Jimmy Carter's presidency) is not the end of the matter, since its judgment merely remands the case to the court of appeals—which may in turn, and in due time, either affirm the grant of the operating license or remand the case to the Nuclear Regulatory Commission (the Atomic Energy Commission having become defunct during the long course of this case) for still further proceedings. There may, indeed, be worse evils than imperfect procedures.

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Interest on Checking Accounts: The Fed, the Banks, and the S&Ls

In a highly controversial decision, the Federal Reserve Board voted on May 1 to allow commercial banks to transfer funds automatically from individual depositors' savings accounts to their checking accounts, if the depositor wants them transferred. This action has been justified as one way of increasing the attractiveness of savings accounts (since, in effect, depositors would be writing checks on their savings accounts) and lowering the cost of making payments by check (since a fee is usually charged when checks "bounce"). Whatever its justification, many see it as an end-run around that part of Regulation Q which implements the 1933 Banking Act's prohibition against paying interest on checking accounts (demand deposits). Because the new regulation is so controversial, the board has postponed the effective date until November 1 in order to give Congress a chance to respond.

This regulation has reopened the debate over the extent to which financial institutions should be allowed to compete for household funds. Crucial in this regard was a last-minute change championed by the Fed's new chairman, G. William Miller. Whereas the original proposal of February 2, 1978 (unanimously supported by the board) would have required that thirty days' interest be forfeited on funds transferred from savings to checking accounts, the final version dropped this requirement (by a 4–3 margin, with Chairman Miller casting the deciding vote). Thus, each commercial bank will be free to decide what penalty (if any) it will charge for transferring funds. (The lack of a forfeiture requirement is significant because household checking accounts generally turn over more than once every thirty days. A forfeiture requirement would lower the incentive for persons to put funds in commercial bank savings accounts instead of S&L savings accounts or commercial bank checking accounts.)

There is some difference of opinion among commercial bankers on what to expect from the new rule. Most of them think banks will be net earners on the additional deposits the rule should produce—that is, returns will more than offset the increase in interest payments. But others, expecting the increase in savings deposits to be small, think banks might simply end up paying interest on deposits that were formerly "free," with an ensuing decline in profits. This concern may explain why one third of the commercial banks commenting on the proposal objected to it.

In addition, thrift institutions (savings and loan associations) still vehemently oppose the Fed's action, arguing that it will give commercial banks a clear competitive advantage in attracting household savings. Thrifts are now permitted to pay one-quarter of a percentage point higher interest on savings accounts to offset the commercial banks' monopoly on checking accounts. Many in the thrift industry believe the savings and loans' competitive position will be jeopardized when people can be relieved of concern about overdrawing their checking accounts simply by placing savings in their commercial banks. The U.S. League of Savings Associations, an industry trade group, is challenging the Fed's action in the courts on the grounds that it effectively violates the statute prohibiting the payment of interest on demand deposits.

The regulation of interest rates has long been used to limit the competition for funds within the banking industry. At issue is the fact that savings and loan associations and commercial banks (both big and small) compete for the same deposits but lend in different markets. Savings and loans primarily finance home mortgages, small commercial banks lend locally to both households (consumer loans) and small businesses, and large commercial banks generally lend a major share of their deposits to large corporations. Consequently, any change in interest rate regulation ultimately affects the distribution of funds among these borrowers.

The Fed's action has prompted not only debate over the narrow issue at hand but also renewed interest in financial reform legislation currently stalled in the Congress. A Senate bill backed by the Carter administration (S. 2055) would allow both banks and savings and loans all across the country to provide NOW (negotiable orders of withdrawal) accounts—interest-bearing transaction accounts that are, in effect, checking accounts and are currently available only in New England. In the House, Representative Fernand St. Germain (Democrat, Rhode Island), chairman of the House

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Subcommittee on Financial Institutions, recently introduced a bill (H.R. 8981) to permit interest-bearing checking accounts at all types of financial institutions. In part, congressional action has been delayed by the savings and loan associations' concern that if they received authority to offer interest-bearing transaction accounts they would have to give up their quarter-point interest payment advantage. The recent Federal Reserve Board action may be intended to convince the thrift industry that change is imminent and that some legislative compromise would be preferable to leaving the matter to the Fed.

Should Polluters Pay?

In a recent nationwide Harris Survey, persons over 18 were asked whether they favored or opposed using taxes to induce "socially responsible" behavior on the part of corporations. The main thrust of the survey is illustrated by the first question:

> In general, would you favor or oppose a federal tax system under which companies that are bad polluters of the air and water have to pay higher taxes, and those companies cleaning up air and water pay lower taxes?

Some 82 percent of those surveyed responded affirmatively. (Other questions in the survey related to worker and product safety, job creation, energy conservation, and minority hiring practices. In each case, a majority of respondents supported the taxing of firms that failed to meet some preconceived standard of performance.) While the survey was designed to measure opinion on the general merits of tax incentives, it nonetheless revealed strong popular support for the use of the "polluter pays" principle in managing environmental quality.

It has been argued that the present practice of having government set specific emission standards is a less efficient way to reduce pollution than having the government tax each unit of waste discharged. A tax on pollution emissions, if properly designed, would cause the discharger to consider the "opportunity cost" of its actions. In other words, if the cost of treating emissions were lower than the tax, the firm would reduce its emissions, but if treatment costs exceeded the tax, the firm would continue to pollute. By the government's setting the tax at the proper level, all firms, taken together, could be induced to meet overall environmental standards.

Treatment costs vary widely among industries and among processes within plants. As an example, consider the following: In 1976 the Council on Wage and Price Stability analyzed a proposal by the Environmental Protection Agency to require the steel industry to reduce effluents discharged into rivers. The council concluded that the marginal cost of removing a ton of suspended solids would be $18,000 in one steel-making process, but only $2,000 in another in the same plant. So if the federal government were to impose a tax of (say) $5,000 per ton of discharge, the firm would be likely to do more to clean up the second process and less to clean up the first than it would under EPA's proposed standards. Management would adjust its clean-up efforts on the two processes until the additional cost of treatment in each case would equal the $5,000-per-ton tax. If the new level of emissions were, in EPA's opinion, too high or too low, the agency could remedy this by raising or lowering the tax. The result would be a social cost of meeting any emission standard significantly lower than under EPA's proposal.

Another benefit of a "polluter pays" approach is that environmental regulators would not need to set specific effluent guidelines for thousands of firms, based in each case on the "best" control technology available. (They would, of course, have to establish overall emission standards and monitor emissions so as to apply the tax.) Still another benefit is that the prices of goods would rise to cover the amount of the tax, thus causing consumers to reduce their purchases of environment-intensive goods.

In a way, it is curious that the United States relies on uniform standards and specific technologies rather than on market principles to manage its environmental problems. At this point, Czechoslovakia, East Germany, Hungary, Poland, West Germany, Finland, France, and the United Kingdom all use taxation or effluent fees of one type or another as a means of reducing the cost of attaining their environmental goals.

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The CAB, the Congress, and Competition for the Airlines

With different House and Senate bills to reform airline regulation moving slowly through Congress, the Civil Aeronautics Board under Chairman Alfred Kahn is proposing measures of its own to stimulate competition in the industry. All three proposals seek more flexible pricing and freer entry into airline markets. So the question is, if the CAB can do these things on its own, why does the Congress need to act? Or are the three proposals substantially different?

In the area of fare flexibility, the CAB's proposals appear to be much like those in the Congress. On April 13, 1978, the CAB proposed to change its current rate-making policy—which, broadly speaking, establishes the standard fares that scheduled airlines charge the public on each route. The CAB would (1) establish a "zone of reasonableness" within which proposed fares would not ordinarily be suspended as too high or too low, with the zone's ceiling being the CAB-determined standard fare for the relevant market and the floor one half that amount, (2) remove the fixed-percentage relationship between the fares charged to first-class and coach passengers, and (3) allow the airlines to introduce discount fares within the zone without providing economic justification.

The airline reform bill that recently passed the Senate (S. 2493) would likewise establish a zone of reasonableness—ranging in this case from 5 percent above the standard fare to 35 percent below it—and would require the CAB to issue regulations encouraging lower fares during off-peak hours. While the floor is somewhat more restrictive in S. 2493 than in the CAB's proposal, the board would be authorized to lower this floor further if that were determined to be in the public interest. (The ceiling, however, could not be altered.) The House bill (H.R. 12611), recently voted out of committee, would establish a zone of reasonableness with a ceiling equal to the standard fare and a floor 25 percent below it during the first year and 50 percent below it thereafter.

Both Congress and the CAB are trying to bring a measure of price competition to interstate air service. (Traditional CAB regulation, in discouraging fare reductions, has led airlines to compete mainly on the basis of service.) But whether the current efforts—especially the CAB's—would succeed in stimulating the kind of price competition apparently envisioned is problematical.

The reason is that, while the zone-of-reasonableness provisions in both the House and Senate bills provide standards for ultimately determining whether a fare is lawful and are thus stronger than the CAB's provision (which would apply only to the suspension of fares), neither attacks the question of "preferential, prejudicial, and discriminatory" pricing. Under the existing statute, there are two principal grounds on which the board may suspend a proposed fare or ultimately find it unlawful: (1) if the fare is "unreasonable" (too high or too low) or (2) if it is "preferential, prejudicial, or discriminatory" (treats passengers differently or unfairly—as, for example, charging a passenger on the first leg of a one-stop flight more than a passenger making the entire journey). Typically, what has happened is that a low fare is contested on reasonableness grounds and, if it is suspended by the CAB, the carrier withdraws it rather than incur the expense of an investigation. Under the new CAB proposal, the board could not suspend fares within the zone for reasons having to do with "reasonableness," but could still suspend them on grounds of "preference, prejudice, and discrimination." Thus, some of those seeking to bring true price competition into the airline industry fear that, under this scheme, the grounds for fare suspension would merely be shifted from "reasonableness" to "preference, prejudice, and discrimination"—if not by the board, then by opponents of a fare decrease who might get CAB policy overturned in the courts. This is one reason why many of those advocating reform—including the current board—insist that congressional action is essential.

Closely related to the issue of fare flexibility is that of market entry. The root of the problem is the statutory requirement that applicants for new routes obtain a "certificate of public convenience and necessity" before they may begin service. Although CAB policy has recently grown more liberal in this regard, gaining entry is still a costly process. Market entry is related to the issue of pricing flexibil-

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ity because if certification requirements impede entry into new markets, there is a chance that airlines already serving a market will tend to maintain fares near the flexible-pricing zone's ceiling. In other words, flexible pricing may not lead to effective competition in all markets unless there is a realistic threat of entry into markets where fares are high or service is poor.

In the Oakland Service Case, the CAB has departed from its past practice and proposed multiple permissive route awards—that is, it would certificate all airlines applying to fly a particular route rather than just one or two. It has also proposed to drop the requirement that, as a condition for approval, airlines applying for route authority prove they can earn a profit on the route and will not divert traffic from other carriers. The dropping of this requirement, if implemented and upheld by the courts, would eliminate the major barrier that airlines have faced in expanding into new markets.

At first glance, the entry reforms being considered by Congress do not seem to go so far as the CAB's. The Senate bill has an "automatic market entry" provision that would allow all scheduled interstate airlines, plus supplementals (charters) and large intrastate airlines, to enter one new route a year for the first two years after the bill's enactment and two new routes a year thereafter, without getting explicit CAB approval. Routes awarded under this provision could total no more than 3,000 statute miles each year for each airline. The House bill, which would apply to the same groups of airlines, would allow automatic entry into one new route during the first year, but after that would require the CAB to submit a study of the program to Congress before extending it any further. Both bills would allow airlines to "protect" a few of their routes from automatic entry by other carriers (though this protection would be phased out in a few years).

The major difference between the congressional and CAB initiatives on market entry is that the new CAB policy of multiple permissive route awards would still require board approval for each new route, whereas the Senate and House bills would make certification automatic in a limited number of cases. Moreover, both bills would liberalize the statutory standards governing CAB policy toward the granting of certificates. This may be especially important if (as is likely) the board's policy initiative is challenged in the courts.

To return to our question, is new legislation needed if true price competition in air service is to come to pass any time soon? The answer would appear to be yes. For one thing, it could be a long time before the CAB's new policy is fully implemented through normal rule-making procedures and court tests. Also, the CAB may not have the authority to do all that it proposes—that is, its initiatives might be reversed in the courts. In fact, it has been said that if Congress fails to act, the opponents of the CAB's proposals would, *because of that*, have an easy time convincing the courts that increased competition is not in the public interest. Finally, if existing law allows the present CAB to move in a procompetitive direction, it would allow a future CAB to move just as far and just as rapidly in an anticompetitive direction. In view of all this, it would seem that the ultimate decision on how (and to what extent) the airlines will compete must be made by the Congress, not by the CAB.

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Viewpoint

Edward J. Mitchell

Oil, Film, and Folklore

A FEW YEARS AGO some grade school children were asked to comment on the world's water problems. One child opined that "if the Mississippi River were straightened out, it would reach much farther." This little girl was predisposed to remake the world merely because she could conceive of its being better. It is my theme that such predispositions account for much of current U.S. energy policy and, in particular, for our government's attitude toward the petroleum industry.

The question I address here is how the petroleum market should be organized: should we have a completely free market, a market tightly controlled by government, or a national oil company that produces and sells all our energy? Before answering that question we should ask what kind of market we have now and how that market is working. Unfortunately, descriptions of the current petroleum market lack the forcefulness they deserve because, I presume, most people find it hard to imagine themselves in the petroleum business. So let me tell the story of the past half century of that business by analogy, supposing that the entertainment industry was organized along the lines of the petroleum industry.

The Analogous World

In this analogous world, as in ours, there was a great depression in the 1930s, and an oversupply of people wanting to enter the movie business, the recording business, and the like. This meant that most actors were unemployed, while a few (like Cagney and Bogart) were big financial successes. This was judged to be unfair to the less popular actors. The government therefore began to regulate the production of successful movies. These would be strictly limited in number and in the number of showings, in order to leave a pent-up demand for movies that could be satisfied by unpopular actors and producers. To keep the income of all actors and moviemakers high, the total number of movies made would also be reduced so that the price of admission could be raised.

The plan worked spectacularly for the unpopular actors until the 1950s when foreign movies, which were not restricted in supply and were cheaper to make than the U.S. movies, began to be imported. The threat of foreign movie competition caused the government to introduce movie import quotas. Only a small number of foreign movies would be allowed each year so as not to disturb the domestic movie business. But which movie theaters would get to show the foreign movies? After all, since these movies were cheap, everyone wanted them. It was decided to allocate them disproportionally to movie theaters in the Midwest because the theaters there were otherwise too small to be economical. The problem with this solution was that midwesterners did not like foreign movies. So while the foreign movies were given to the midwestern theaters, they in turn sold them back to eastern theaters—which was of course highly profitable for the midwestern theaters, but not an especially efficient way of working things.

In 1960, attention turned to recording artists. Record prices were also to be controlled. At first it was decided to charge a different price for each record according to its cost of production. But this proved impossible, given the millions of records involved, so it was decided to set the prices of records according to the re-

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gion where the recording artist was born, with the country divided into six regions. Because the price was set low, some recording artists decided they could make more money as truck drivers. As a result, the supply of recordings fell and there were not enough to go around. The law provided that recordings made and sold in the same state were not subject to price controls, which led, of course, to booming record sales in those states where good singers happened to be born. People who liked good music moved into those states.

The law provided that recordings made and sold in the same state were not subject to price controls, which led, of course, to booming record sales in those states where good singers happened to be born.

It was also decided that since old singers had been trained in a period when costs were lower, they should be paid less than young singers. Also, it was argued, old singers were already committed to singing, so the low wages would not drive them out of the market. Young singers were paid much more so as to try to encourage youth to sing. It was assumed that young people would not look ahead to what their prospects would be when they were old.

In 1971, the record shortage was accompanied by a movie shortage as price controls were put on U.S.-made movies. Some U.S. producers and actors moved abroad. In order to make up the shortage, the country began importing foreign movies made by U.S. producers and actors abroad. Foreign governments saw the opportunity to milk this continued strong demand for foreign movies by placing enormous taxes on their movie exports. The prices of foreign movies made by Americans increased several times, while the prices of U.S.-made movies remained under government control. People blamed American movie producers and actors for the high prices. With foreign prices soaring and beyond our government's control, price controls were extended to theaters and the movies were allocated among them. But the government based its estimate of movie demand in each area on old data. As a consequence, theaters in Michigan stayed open twenty-four hours a day in an effort to attract customers, while in New Jersey moviegoers waited in line six hours to get into a theater.

With the low controlled prices for domestic movies, there were few movies around and all the theaters wanted them. The government decided to give the cheap U.S.-made movies to theaters that seated less than ten people because these theaters were uneconomical. Such was the government subsidy to small theaters that you could build a new small theater and get your total investment back in the form of government subsidies in seven months.

When a new President was inaugurated in 1977, he announced a program that would solve the crisis of high prices and little entertainment. His solution was to tell Americans to stop going to the movies and stop listening to records. In the long term he promised new and cleaner forms of entertainment that would cost three to ten times as much as current entertainment. This, he said, would save consumers from being ripped off by conventional movie producers and recording artists.

At that point, some professors took an ad in the *Washington Post* to argue that our entertainment policy had caused artificially high prices, unemployment for American actors and singers, far more foreign movies than Americans really wanted to see, enormous profits for foreign governments, the continued use and building of minuscule theaters, and (looking down the road) the prospect of scandalously expensive forms of entertainment that people might pay for simply because nothing else was available. The professors' solution was to let anyone entertain who wanted to and let anyone pay for it as he or she saw fit. They claimed that if the government simply stepped aside, the crisis would sort itself out. Journalists, lawyers, and politicians were especially hostile to this idea, calling it naive and a weak response to a serious national challenge. They said it would result in large incomes for successful entertainers, most of whom came from just one or two places, neither of which was New York or Washington.

The Actual World

Of course, the entertainment policies and programs I have just described would be silly, to use no harsher word. No one looking at the entertainment business today would argue that

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these policies would have served us well. Yet, replacing "movies" with "oil," "records" with "natural gas," and "theaters" with "oil refineries," the foregoing offers at least a superficial glimpse of the history of the U.S. petroleum industry over the past half century. It is superficial because no short description could do justice to the misguided imagination exercised by federal bureaucrats and politicians.

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The themes of petroleum regulation over the past generation have been

(1) to maximize the cost of producing energy by subsidizing wasteful enterprises, sources, and technologies and by discouraging efficient ones, and

(2) to offer selected groups of consumers cheaper energy, while forcing other consumers to pay far more than is necessary.

It is important to stress that all of our energy policies, programs, and plans were carefully thought out, fully debated, and well supported in volumes of congressional testimony and executive-branch studies. All interest groups and ideologies were represented. Debates were carried out and programs initiated under Democratic and Republican, liberal and conservative, administrations. All of these administrations were responsive to public opinion, and all of the agencies involved were responsible—that is, accountable—to the public. Their noble purposes varied from conservation to national security to consumer protection. There was only one common element in all these plans: the belief that the public would be better served by government control than by the market.

Doubtless there are government interventions that would improve upon the petroleum market. We must, for example, control environmental damage, deal with OPEC as a monopoly, and prepare for foreign supply interruptions. But we must also guard against government controls that are used to further special interests or naive ideologies. In the past these have had harmful effects on our standard of living.

Three social forces have led to the anti-economic policies that have undermined the petroleum market:

(1) the political influence of various interest groups,

(2) the natural interest of politicians, bureaucrats, and Washington lawyers in expanding their influence through new government programs, and

(3) the application of simple-minded and abstract ideology to complex situations.

Of these forces, the role of the first two is, I think, well understood. It is to set up institutions like market-demand prorationing, the depletion allowance, and oil import quotas. What is not understood is how the influence of special interests has declined and the role of ideology risen.

The oil industry used to be represented by a spectacularly successful lobby. But since the mid-1960s, the influence of that lobby and, therefore, of the large oil companies has plummeted. Now the depletion allowance has gone, import quotas have gone, and government controls on oil and gas hold the prices of these products to a fraction of the competitive free-market level. It would be hard to find an industry that has suffered more from punitive legislation in the last decade than the oil industry (though I would exclude small oil producers and refiners from this statement).

Unfortunately, the passage of influence from producers to consumers has not resulted in an energy policy favorable to consumers. The problem is that there are, in fact, no organized consumer interests (except in some cases where the consumers are industrial firms). To be sure, there are politicians with liberal voting records who claim to favor consumers and there are the so-called consumerists. But liberalism and consumerism are ideologies, philosophies, or predispositions: they have no connection with consumer interests. Generally, these ideologies favor safer, cheaper, less polluting products; but it is not certain that the consumer is better off if a particular product is safer, cheaper, or less polluting. An improvement along one dimension of a product does not mean, when the effects on all dimensions and on all products are considered, that the consumer is better off.

A classic example of this is the regulation of natural gas prices. Low ceiling prices mean

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cheaper gas for some people. But most Americans heat not with gas but with oil or electricity. Smaller gas supplies (as a result of lower prices) mean that more people must use oil or electricity, so that the prices of oil and electricity are bid up. Thus, users of oil and electricity are worse off. Since they outnumber users of gas, there are more consumers worse off from gas price controls than better off. Yet consumerists still favor gas price controls. One is hard pressed to find an economist who regards natural gas price controls as favoring consumers, because most economists remember the elementary point that a reduction in the supply of one commodity raises the price of substitute commodities. Because consumerism is an ideology and not an expression of consumer interests, this point is ignored by consumerists.

The result is that many politicians vote against their constituents' interests. Politicians from New England consistently reject natural gas deregulation even though their area of the country consumes little natural gas and lots of fuel oil—whose price is pushed up by natural gas price controls. They are not alone. The distribution of votes on energy bills in the House of Representatives is overwhelmingly along ideological lines. Some 80 to 90 percent of these votes can be predicted merely by looking at a congressman's liberal-conservative rating by Americans for Democratic Action (or at similar ratings by Americans for Constitutional Action or by the Consumer Federation of America). It seems to matter little whether the congressman is a Democrat or Republican, from a producer or consumer state, an urban or rural area.

Folklore and Reality

In spite of the oil shortages, long lines, and sudden price increases induced by government planning, many citizens still fear that the petroleum industry is a monopoly (though they may not be quite sure what that is). And since it is a monopoly, government must protect them from it.

Now, there are standard tests for monopoly, one of them being the existence of prolonged high profits. A number of studies (including one of my own) have looked at oil company profits over the last two or three decades and have concluded that oil company stockholders have fared no better than stockholders of other manufacturing corporations, no matter whether one considers basic accounting data or stockholder gains in the form of dividends and stock price appreciation. The most recent of these studies, one by Shyam Sunder of the University of Chicago, came to the usual conclusion that oil company profits were about average over the past fifteen years—but a leading wire service reported Sunder as showing the reverse, that profits were high. As might be expected, the erroneous report was carried in all the major newspapers of the country. It may be that the decline of literacy has gone further than we think, or that the power of ideology is great enough to turn printed words inside out to accommodate the prejudices of the true believer. I am inclined to the latter interpretation. A recent survey on competition in the oil industry showed that university professors who are economic experts on the industry hold views directly opposite to those of journalists on every issue of substance.

Actually, because oil company profits are so small a fraction of oil prices, they cannot really be a serious concern to the informed consumer. In 1974, a banner year for oil profits and the year of the alleged oil company "rip-off," accounting profits of the largest fifteen integrated oil companies were just over 2 cents per gallon of gasoline and cash dividends were just over half a cent. Had stockholders of all oil companies agreed to convert their companies to not-for-profit philanthropies and forego their dividends, the resulting decline in consumer prices in 1974 would have been one-twentieth of the decline that could have been produced by removing federal gasoline excise taxes and about one-fifteenth of the profits earned by independent gasoline dealers. In fact, the decline would have been entirely offset by a minor increase in state excise taxes that year.

Indeed, if oil companies operated as philanthropies, oil prices would almost certainly rise since, in this world, *profit is the only force operating to reduce costs.* All other things being equal, to maximize profits one must minimize costs. Politicians and bureaucrats (the public-sector substitutes for private businessmen) are interested not in minimizing costs but rather in maximizing status and influence —and, possibly, in some vaguely defined or un-

(Continues on page 55)

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THE EMERGING MARKET IN AIR POLLUTION RIGHTS

Bruce Yandle

If from any revolution in nature the atmosphere became too scanty for the consumption, . . . air might acquire a very high marketable value.

—John Stuart Mill
Principles of Political Economy
(1862 edition)

IF AIR POLLUTION can be described as a "revolution" in the nature of the "atmosphere," then John Stuart Mill's early observation on air quality may well have come of age. For today we can see the beginnings of the process by which clean air—what is called "air quality" in regulatory language—enters the market. As a result of recent actions by the U.S. Environmental Protection Agency and the Congress, property rights in air pollution emissions are now being traded, albeit tentatively and in a rudimentary way.

A system of marketable air emission rights —that is, rights to emit pollutants into the air —could provide an astonishing array of social benefits. First and of key importance, such a market would make it possible both to hold air emissions to a desired level and to allocate them to those who produced the greatest economic benefits to society. Firms desiring to expand production could do so if the value of their product enabled them to purchase the right to use scarce air quality. The possibility of trading the rights would allow for growth and change. Second, having to pay for air emission rights would make the value of air quality obvious to both buyers and sellers, thus leading

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to conservation and an efficient use of pollution control devices. Moreover, the fact that emission rights had a cost would cause firms to search for alternative methods of producing their products, thus creating an additional incentive for discovering and implementing new control technologies. After all, by reducing emissions below some established level, a firm could generate a saleable emission right—that is, the right to bring the amount of pollution up to a predetermined level.

It is certainly conceivable that an air emission rights market could do much of the job being done by environmental regulators. Moreover, through allocating air emission rights, the market would establish priorities for industrial expansion, while inducing technical efficiency in the control of air emissions. Air quality would be maintained or even improved, efficiency enhanced, and social conflict reduced.

Air Quality: The Costs of Inflexibility

Competing uses of air quality (clean air) generate conflicts reminiscent of those caused by competing uses of land. But today, instead of pitched battles between farmers who want to cultivate crops and ranchers who want open grazing, we have controversy between those who want cleaner air to breathe and those who demand air-using products such as steel, food, medical care, electricity, and transportation—with workers who are trying to protect their jobs often joining in.

Traditionally, air quality (indeed, the air itself) was treated as a free good—one belonging to everybody. Since there was no rationing mechanism, the capacity of the air to assimilate pollutants was used intensely in certain locations—which is to say that pollution became a problem. Responding to the clamor of competing air users who were unable to bargain in a "propertyless" environment (one cannot trade pieces of something that belongs generally and in an undifferentiated way to

Glossary

Regulators and economists, in the course of conducting their business, invent jargon that is likely to be unfamiliar to most readers. The terms in this article that may need explaining are defined below, in the order of their occurrence.

Air quality

Generally, the physical and aesthetic characteristics of air that relate to a person's level of satisfaction; technically, a measure of a specific amount of a pollutant defined by EPA's "national ambient air quality standards."

Air emission rights

In a strict sense, a legally enforceable property right—a title or deed—to a specified maximum rate of emission for a precise pollutant (for example, 100 tons of SO_2 a year) in a given place.

National ambient air quality standards (NAAQSs)

A set of maximum concentration levels for air pollutants that are to be reached and maintained throughout the United States. NAAQSs were provided for by the 1970 Clean Air Act, which established a two-part standard: primary standards (to be attained generally by 1975) relate to human health, and secondary standards (to be achieved in "a reasonable time") relate to property, crops, livestock, and public transportation. EPA's regulations cover particulate matter, sulfur oxides, carbon monoxide, photochemical oxidants, hydrocarbons, and nitrogen oxides.

Stationary emission source (major)

A structure, building, facility, or operation with "allowable" emissions (after the application of controls) of 100 tons or more a year of particulates, sulfur oxides, nitrogen oxides, or hydrocarbons, or 1,000 tons or more a year of carbon monoxide. Narrowly interpreted, a single stationary machine with the emissions noted here. (Mobile sources, by contrast, are automobiles, locomotives, and other wheeled or tracked vehicles.)

State implementation plan

An environmental management program designed by a state to meet the requirements of the Clean Air Act. Includes the identification of stationary emission sources, the development of plans for controlling them, the establishment of procedures for preconstruction review and enforcement, and the assurance of timely attainment of national air quality standards.

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everyone), Congress passed the Clean Air Act of 1970. That act identified clean air as being in short supply—meaning that, at a price of zero, the amount of clean air demanded for use is greater than the amount available. To deal with this problem, the act set national standards for ambient air quality (the quality of air surrounding any given place), established deadlines for meeting the standards, and required states to adopt EPA-approved implementation plans to meet them. To this end, specific emission standards determined by available technology were set for new emitters of pollutants, and construction review procedures were instituted to make sure the new emitters complied with the relevant regulations.

One effect of the Clean Air Act has been to limit economic growth in areas where ambient air conditions are below the national standards (nonattainment areas, in the EPA vernacular). For example, as a result of the act, a major new emission source (roughly, a building or operation emitting 100 tons of certain pollutants annually) may not be allowed in a nonattainment area. The act has also limited growth in "pristine" areas, such as those containing national parks. Thus, development has been restricted in some places because they are clean, and in others because they are dirty.

Predictably, contention over air quality standards developed between forces favoring industrial development and those that were more concerned about the natural environment. In some cases, the cost of improved environmental quality was so high as to be almost unbearable—so high, in fact, that compromises had to be made. For example, in the winter of 1973-74, EPA granted a total of seventy-seven emergency variances for sulfur dioxide emissions to ease the conversion from burning Arab oil to burning higher sulfur coal. Another compromise, noted by Allen Kneese and Charles L. Schultze, occurred in 1973 when EPA relaxed its more stringent emission control approach and permitted the use of tall smoke stacks for dispersing sulfur oxides from smelters and power plants. At the time, the smoke stack approach appeared to be the only alternative to plant shutdowns.

While too many compromises may have been made for desired quality standards to be met, these compromises were thought to be proper at the time—that is, thought to make possible less painful *and sufficient* progress toward the attainment of national standards. Certainly EPA's task of managing things so as to achieve its goals and still allow some flexibility was not easy. As it became apparent that progress toward meeting national air quality standards was too slow, and as environmental regulators therefore grew less inclined to make exceptions, it was recognized that the air quality standards allowed little room for industrial growth in regions that were behind schedule in achieving cleaner air.

Ultimately this had to lead to a confrontation between costs and benefits. Thus, in November 1976, EPA explicitly considered—but rejected—a trade-off policy that would balance economic costs and air quality benefits:

> Some have argued that a new source should be allowed to worsen existing [air quality] violations if a "cost-benefit" analysis indicates that the economic costs of necessary emission controls . . . are excessive in relation to the resulting air quality benefits . . . [but] the Clean Air Act simply does not allow such an approach. Application of such a policy could allow further delay in achieving already-overdue standards. [41 *Federal Register* 55527]

In other words, EPA was saying, the act treats the damage that additional emissions cause in nonattainment areas as infinite in value.

The 1970 Clean Air Act was like a first land-use zoning ordinance in that it had to provide for both conforming and nonconforming users. The act implicitly gave initial air emission rights (not called that in the act) to firms in both categories. However, the quantity of rights the nonconforming firms received fell short of the quantity they were already using —the shortfall, of course, measuring the improvement that had to be made. While the rights were important (because firms could not operate without them), their potential value was reduced by the fact that they could be used only for existing plants—not even by existing firms for their other plants. The rights could not be sold, bartered, or stored for future use—nor, indeed, were they strictly defined. If direct transfers of rights had been allowed, it is conceivable that a market would have developed at that time. Potential users would have paid for air emission rights in particular locations; and those who preferred cleaner air might have

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joined together to buy rights and hold them, thereby expressing their true demand for air quality. But since rights were not transferable, the advocates of cleaner air turned to the political process and the courts as their avenues for expressing their preferences; and the firm that wished to expand either met the standard or perhaps acquired an existing plant, merged, or adapted one of its own plants to produce a similar product without changing the level and types of emissions. In nonattainment areas, EPA attempted to assist firms that wished to expand existing emission sources (existing plants), but was not so flexible for new plants that would be major sources of emissions.

Under a strict interpretation of the air quality controls, there are two kinds of problems for expanding firms: First, since new major sources of emissions are excluded from certain regions, managements may have to settle for second-best locations. (While the social costs and benefits of settling for second best are not clear, what is clear is that some regions gain air quality as a result, while others gain income and goods, and all of society most likely pays more for food, health care, education, clothes, soft drinks, and many other products.) Second, existing firms that wish to expand by building new emission sources are treated much the same whether or not they are already operating plants in the area. (While some assistance may be offered to help in meeting standards, it may not be enough to prevent the expanding firm from having to move to another location.) In either case, the adjustment costs of settling for second best or of holding down growth are in addition to the direct costs of treating air discharge. According to estimates by the Council on Environmental Quality, the direct costs alone for controlling air pollution from stationary sources will total $74.3 billion over the ten-year period 1975–84. Both adjustment and direct costs could be reduced if exchanges of emission rights were encouraged.

A Market Begins

Logically enough, EPA's shift to a stricter policy on new sources of pollution forced it to confront the problem of in-plant expansion (but not so much, to start with, the problem of in-firm expansion generally). In the course of the summer and fall of 1976, certain kinds of internal trade-offs began to be allowed on a case-by-case basis, the initiative apparently coming from EPA officials in no-growth areas. Thus, EPA might approve an expansion in one production operation if the resulting increases in a particular kind of emission were more than offset by reductions in the same emission from another source in the same plant. For example, a steel producer might expand production by replacing open-hearth furnaces with basic oxygen furnaces of a larger capacity. Internal trade-offs of this kind brought valuable flexibility, giving managements some room to achieve certain of their growth objectives by adjusting both product mix and production technique. Plant-specific emission rights had begun to emerge and property rights in air quality use had reached the barter stage. This result may not have been intended by EPA—indeed, it seems not to have been—but nonetheless a crude and limited market was taking shape. (Opportunities for using this market were, however, restricted somewhat by later court decisions.)

More specific possibilities for expanding the air emission market developed about the same time. In a speech on November 17, 1976, John R. Quarles, then deputy administrator of the Environmental Protection Agency, proposed that industrial expansion be made possible in nonattainment areas by allowing firms to trade their emission rights. Quarles went on to suggest that firms seeking to grow either by expanding their operations in one area or by moving into a new area would be allowed to obtain emission rights from existing emission sources in the same area. As with internal trade-offs, a greater than one-for-one emission offset was a given requirement. While recognizing that the offset idea was not perfect, Quarles said it was the only policy that would satisfy the Clean Air Act "without imposing intolerable restrictions on growth."

Not all reactions to Quarles's suggestion were favorable. Bethlehem Steel, for example, ran half-page advertisements in major newspapers calling the policy a "Catch-22." Bethlehem was saying, in effect, that air emission rights could not be found in areas convenient to its markets. Industrialists in Texas expressed a similar concern about petrochemical production: how could firms in the same industry

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possibly generate a greater than one-for-one offset? (*Journal of Commerce*, May 25, 1977.) On the other hand, environmentalists charged that the trade-off proposal would let the camel's nose under the tent—a little dirt today, a lot more dirt tomorrow. Their concern might have been somewhat relieved had Quarles's announcement not been so limited—that is, if it had allowed for the purchase of offsets by all of the interested parties.

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As an example of some of the problems of a trade-off policy, let us consider the Sohio case. For three years, Standard Oil of Ohio (Sohio) had been seeking permission to build a pipeline terminal near Long Beach, California, in order to bring Alaskan Slope oil to the U.S. market, but its efforts had been blocked by California's regional air plan. Without the terminal, the oil would have to be shipped around South America or through the Panama Canal (in smaller tankers) to Texas—or, possibly, to Japanese refineries from whence finished products would be reshipped to the U.S. market.

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Then Sohio offered a solution to the impasse. It would purchase an old (and polluting) facility in the Long Beach area, close it, and build the new (and cleaner) pipeline terminal. The transfer of emission rights from the old to the new facility was explicit in the offer—as was the idea that, after the transfer, these rights would have a new and higher value both to Sohio and society. The fact that a voluntary exchange could result in both cleaner air and more oil for U.S. consumers had appeal. But it was not yet clear just how widely the trade-off policy would be applied. Moreover, Sohio's offer was somewhat experimental. Many legal and technical questions would have to be answered before an actual trade could be permitted.

The Regulators Respond

EPA, recognizing that the trade-off policy was a matter of considerable public interest, sought public comment on the idea through an "interpretative ruling" published on December 21, 1976. The ruling, without ever using these words, outlined the conditions for an extremely limited market in emission rights for nonattainment areas—but a real market nonetheless.

> The ruling provides in general that a major new source may locate in an area with air quality worse than a national standard only if stringent conditions can be met. These conditions are designed to insure that the new source's emissions will be controlled to the greatest degree possible; that more than equivalent offsetting emissions (emissions offsets) will be obtained from existing sources. . . . [41 *Federal Register* 55525]

Respondents to EPA's announcement asked (1) whether states would be able to tighten emission standards for existing sources, making them more severe than national standards, in order to release air emission rights for use by other (new) sources, (2) whether a source would be able to persuade (or pay) a competing source to further control its emissions in order to permit the new source to be built, and (3) whether states would be required to develop a new regulation for each emission offset situation [41 *Federal Register* 55526]. EPA answered that states could set standards more stringent than those of the federal government, but would not be required to become air emission brokers. State regulators would enforce standards, review construction permit requests to ensure that they met requirements, and approve emission exchanges if offsets were included in an EPA-approved state plan.

The 1977 amendments to the Clean Air Act (enacted August 7, 1977) allow EPA's interpretative ruling to continue in operation for nonattainment areas until July 1, 1979. At that time, any nonattainment area not covered by a state implementation plan that ensures re-

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gional achievement of national air quality standards by December 31, 1982, will face a ban on new major sources of emissions—in effect, a limited industrial growth situation. If a state initiates an offset-trading program, that program can continue until July 1, 1979, and beyond under EPA-approved, state-operated arrangements.

The Limited Market

It is clear that EPA's interpretative ruling set in motion a crude but limited market mechanism. Along with the requirement that nonattainment areas demonstrate progress toward meeting national air quality standards, the rules of the market appear to be these:

(1) In treating its discharge, new major emission sources must use a technology that yields "the lowest achievable rate of emission." This means that a new source cannot gain additional emission rights by shifting from an inferior to a superior technology. Nor can it sell existing rights if new, cleaner technology is developed.

(2) Only the same kinds of emissions are subject to exchange. For example, emissions of SO_2 may be substituted for emissions of SO_2.

(3) An emission offset of more than one-for-one is required, or, to put it another way, each transaction carries an in-kind tax.

(4) There can be no banking of emission credits or rights, for these must be used or lost. Also, there can be no net sales or purchases.

(5) Only parties desiring to build new emission sources can enter the market as buyers. Proponents of improved air quality cannot buy emission rights and destroy or hold them.

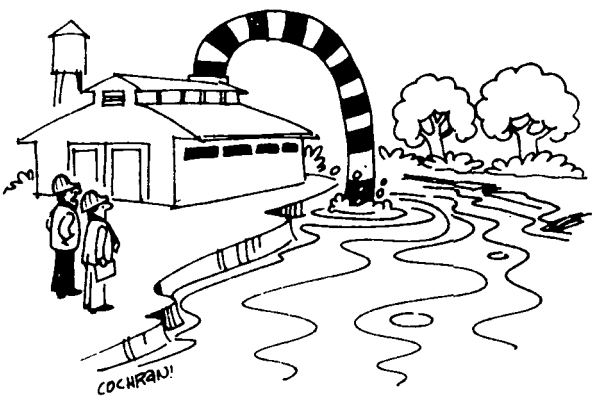
Just how much flexibility does this policy allow? In what circumstances will there be a market?

It is unlikely that a firm seeking to expand a plant will find room within the present rules for fruitful negotiations with a direct competitor. Both firms will tend to have the same costs and the same value for their products, and also to have emission standards based on similar treatment technology. Of course, firms or plants on the verge of going out of business may be potential offset sellers, but their number would be limited. This leaves plants from different industries (and the firms owning them) as the potential bargainers.

A firm desiring to enter a region where no additional emissions are permitted may negotiate with an existing firm that discharges the same emission but produces a different product. Successful bargains can be struck if the right to discharge pollutants is sufficiently valuable to the entering firm. In fact, it might be possible for an entering firm to offer enough to enable the existing firm to treat its emissions more than required by the standard, thereby releasing additional air emission rights and enabling both firms to operate. Alternatively, an existing firm might be induced to reduce its output and thereby its emissions. Again, both the new and the existing plant could operate (the latter at a reduced level), and air emission rights would tend to be allocated to their most beneficial use. The offset policy offers some flexibility, but the market is certainly limited.

Current Transactions in the Market

The Sohio case illustrates the possibilities that EPA's new policy offers to firms wishing to expand in nonattainment regions. Under the ruling, California's South Coast Air Quality Management District has overseen Sohio's effort to find offsets for hydrocarbons, sulfur dioxide, and other emissions that its proposed pipeline terminal would generate. When its original trade-off proposal did not work out, Sohio be-



"It may satisfy the clean air people, but the clean water people will never dig it!"

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gan to pursue the same scheme in separate negotiations with three major Long Beach dry-cleaning establishments and with California Edison. The three dry-cleaners have agreed to equip their plants with tighter emission controls (reportedly at the oil company's expense), thereby releasing emission rights to Sohio. California Edison has agreed to the same arrangement. As of now, Sohio, its engineering studies reportedly completed and its purchase orders for the two transactions standing by, is awaiting final decisions by the state and federal regulators. The value of these transactions is estimated at approximately $90 million.

The Sohio case raised major environmental questions that were considered and answered in public hearings and negotiations. One crucial question was, how much greater than one-for-one should the offset ratio be? At this point, Sohio has been told to plan on the basis of a two-for-one exchange on sulfur dioxide and up to a 7.2-for-one exchange on hydrocarbons. Proponents of clean air see the trade-off ruling as beneficial: with a two-for-one offset, two units of sulfur dioxide would be removed by Sohio for every one unit added, for a net gain from the trade-off of one. On the other hand, those concerned about production costs note that the cost of reducing emissions rises as those easiest to control are eliminated, so that each additional offset in an area becomes more expensive than the one before.

Sohio's search has been a difficult one, and indeed it may turn out that many efforts to find offsets will only uncover violators of existing emission standards—will lead, in other words, not to new "emission rights" but only to the elimination of present violations. Even so, the emission rights market can still offer net benefits when an approved transaction occurs.

While the Sohio case illustrates a potential transaction under EPA's policy, the cases of Volkswagen's Pennsylvania plant and General Motors' Oklahoma City plant illustrate actual transactions. In both of these cases, emission offsets had to be obtained to compensate for hydrocarbons from paint lines and other manufacturing operations. For a time it appeared that VW would not be able to operate its U.S. facility but, after considerable search, the state of Pennsylvania came up with the necessary offset, by agreeing to reduce its own emissions of hydrocarbons from asphalt processing and paving. In the GM case a refinery in Oklahoma City installed improved controls (without being compensated), reducing its emissions in order to make room for GM's.

A trade-off similar to VW's occurred in Virginia when the Hampton Roads Refinery sought a construction permit and the state of Virginia made adjustments in its asphalt operations so as to allow construction. While there might be some costs to taxpayers in these states as a result of these barter transactions (more costly paving operations for public works, for example), there might also be benefits in the form of increased tax revenues, reduced unemployment, and cleaner air.

Gains in efficiency are, of course, difficult to assess when a public body—a state, for instance—changes its operations in order to assist a private firm. Nevertheless, it is possible that the transferability of emission rights could lead to improvements in a state's own environmental control. It is also possible, however, that a state might act so as to put the burden of a new plant's emissions solely on the taxpayers and, figuring emission rights therefore to be costless, continue to seek new industry. In any event, the transactions that have so far occurred—both private and public—imply that air emission rights (like property rights to land and other resources) are transferable and may be of greater social value when used in ways differing from their current use.

Improving the Emission Rights Market

To be sure, EPA's emission rights market is only embryonic and contains a number of imperfections that firms might exploit. Since emission rights cannot be banked, some firms might delay adopting the best treatment techniques in the hope of selling out before the ax falls. Firms entering the market might likewise behave "strategically"—might, since emission rights acquired from other firms must be used or lost (cannot be resold), be less than fully diligent in operating their emissions control systems. Allowing the banking of the rights or their (unrestricted) sale would limit behavior of this sort.

Moreover, since the emission rights obtained by newly constructed plants cannot be held for future use—that is, the only rights that

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can be used are those obtained in accordance with the original EPA-approved plan—a firm needing emission rights will look to the short rather than the long run and will obtain only the amount that fits its immediate needs. If that firm decides to increase its output two or three years later, it will have to wait till construction plans are approved before purchasing the necessary new emission rights—at whatever the going price is then. If rights were bankable, a growing firm could plan and invest more rationally for emission control than it can now. Thus, by precluding the development of a "futures" market in air emission rights, EPA may be limiting the time horizon for pollution control planning and thereby limiting progress toward cleaner air.

The "use them or lose them" policy may indeed provide certainty, though it is certainty of the wrong kind. Contrariwise, there may be insufficient certainty of other kinds. First, any change in a state's overall air quality plan, in the national ambient air quality standards, or in the clean air statute could change the value of all emission rights. Indeed, a change in the direction of more stringent standards could eliminate some emission rights entirely. Emission rights, like any property right, require government protection. If it is uncertain that government will protect them, firms will sharply discount the future value of the rights, and only those transactions that give promise of high return will be likely to occur. Air quality regulators could reduce uncertainty and thereby push forward the investment horizons of emission rights' purchasers by carefully defining all emission rights and by strictly enforcing requirements that emissions be monitored. (Monitoring would protect the nascent property right.) State authorities could add protection to the new property rights by keeping other air quality users from "poaching" and by ensuring some minimum life to emission rights at the time of an approved exchange.

One other problem deserves mention. As noted, requiring a more than one-for-one offset will lead to reduced emissions when trade-off transactions are made. It will also, however, reduce the number of transactions that occur, since it makes emission rights more expensive when traded than when held (that is, there is a tax on the transaction). This will encourage less efficient users of these rights to hold on to —and use—the rights they have, rather than trading them to more efficient users. The efficiency of the market in rights is thus substantially reduced.

An Expanded Market Alternative

The problem of limiting pollution emissions into the air is fundamentally the same as the problem faced when any resource becomes scarce: somehow society must bring about the birth of a market. The approach taken by EPA and the Congress represents one stage in the birth struggle. While EPA's interpretative ruling of December 1976 gives explicit recognition to market forces, further moves could be made to maintain or improve air quality and also ameliorate the shortcomings noted in the present policy.

The problem of limiting pollution emissions into the air is fundamentally the same as the problem faced when any resource becomes scarce: somehow society must bring about the birth of a market.

Consider, for example, a system in which state authorities, after defining the amounts of specific emissions that could be absorbed (in our case, by the atmosphere) in a given region or market, could simply hold an auction for rights to discharge those emissions, letting anyone bid. In calculating their bids, firms would have to consider the costs of alternative treatment, of moving, and of shutting down. And those who wished to remove the rights from the market in order to prevent the emissions altogether would have to consider other ways in which they might attain their goals. (This is to say that all opportunity costs would be considered.) Furthermore, those who happened to be earning extra profits because of the "free" air quality with which they were endowed by location would face the costs they had previously not faced. All users of air emission rights would have the opportunity to gain the continued use of the rights at a cost. Their calculations would take into account future revenues, benefits, and costs and should produce a fairly complete identification of demand. Once the auction were

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completed, emission rights would be like any other private property: owners would respond to changing market conditions by buying and selling as they saw fit. (The system described here is like the one proposed for water quality by J. H. Dales.)

In this system, the first definition of rights would set the maximum amount of discharge —that is, the amount that could not be legally exceeded. As with the offset market, there would be wealth distribution questions to consider here if existing plants obtained saleable assets through the first definition of emissions. But, in our case, if the government desired to improve the conditions of overall air quality resulting from the auction (remember that some rights might be banked or simply destroyed), it would have to enter the market and purchase rights like any other buyer. A full market to a limited quantity of rights would be in operation.

Conclusion

The process by which a previously "free" natural resource enters into a market—that is, the process by which scarcity is recognized, rights established, defined and guaranteed, and the market created—is not an easy one. For this reason, any market in air emission rights may be somewhat limited, perhaps for a considerable time, perhaps permanently. But the market for land is also limited. Owners of land may be required to follow performance standards and zoning ordinances. Excavation, mining, sewage, and waste-disposal requirements further reduce the number of potential property rights that are subject to free market forces. Moreover, in some places land is owned by the state and leased for controlled uses. Still, there is a functioning market for land in which significant rights are freely traded.

One might expect to see similar developments in the market for air emission rights, as it evolves. The property rights approach allowed by EPA's ruling and subsequently contained in the 1977 Clean Air Amendments is akin to land's being zoned and then bought and sold. An alternative approach would be for the government to determine, as it sometimes does with land, what amount (of air quality in our case) is to be used, to hold title to that amount, and to lease certain units of it for approved purposes. An air emission fee or charge might accomplish this, the fee perhaps rising and falling to allocate the fixed number of units among prospective users, much as rents rise and fall to allocate housing.

Either an air emission rights approach or a fee approach would induce cost-effective behavior on the part of polluters—that is, lead them to find the least-cost way of producing goods, given the cost of air use. Despite the improved procedures, however, an unsettled question remains: what is the optimal amount of air quality to be marketed? Given that we lack answers to this question and given the public's unwillingness to release the question for a market answer, we are not likely to achieve total efficiency. But society might wish at least to encourage cost-effective behavior.

The steps taken by EPA may be historic: we may indeed have witnessed the first day of a new market. It is a market created not in the twinkling of an eye by government fiat but in a give-and-take process involving industry, environmental groups, and EPA. None of these set out to create a market or saw the first halting steps for what they were. But if the policy discussed here continues to be successfully carried out, air quality will have joined land, bread, water, and even peanut butter as another product too valuable to keep out of the market. And John Stuart Mill will have called the shot correctly. ■

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Midwest Railroads and Northeast Lessons

John W. Barnum

In the early 1970s when the Penn Central and seven other Northeast railroads went bankrupt, the federal government stepped in with new laws, a new agency to plan a way out of the crisis, and billions of dollars in grants and loans. More recently two railroads in the Midwest have gone bankrupt and there is mounting concern about the several carriers in the region that are still solvent. Congress and the Carter administration are under pressure to ensure continued freight service in the Midwest as was done in the Northeast, and if history is any guide, massive government intervention is again a possibility.

My purpose here is to ask and, I hope, answer two questions. What lessons did we learn—or should we have learned—from the reorganization of the bankrupt railroads in the Northeast? How should we apply those lessons to the railroad problems in the Midwest?

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I believe that six principal lessons were learned in the course of the Northeast bankruptcies and the establishment of Conrail (the corporation formed by Congress to consolidate the viable properties of the bankrupt lines).[1] Most of these lessons are not new, but rather serve to remind us of what we already knew or should have known.

The Six Lessons

The first lesson is that Section 77 of the Bankruptcy Act does not meet the present problems of railroad bankruptcy. Section 77 was designed originally to refloat a railroad that had been sunk by excessive debt but that could, with less debt, operate at a profit. In other words, it was designed for the circumstances of railroad bankruptcy in the 1930s. It did not provide a solution for the railroads in the Northeast that went bankrupt in the 1970s, when the Penn Central, for example, was losing $1 million a day on operations, even without paying local taxes or servicing debt.

Section 77 is not a satisfactory mechanism for reorganizing even one such railroad, let alone for reorganizing a number of them collectively. Its principal shortcoming is that it divides authority between the Interstate Commerce Commission (ICC) and the federal court presiding over the reorganization, making each king of its own domain but neither capable of bringing about a reorganization on its own. Section 77 also makes it virtually impossible for a railroad that is in reorganization to abandon or transfer properties until a reorganization plan has ICC and court approval, and it gives the shareholders of the bankrupt railroad the power to block any merger (including one that might make more sense than a self-contained reorganization from the viewpoint of transportation efficiency or public interest).

By late 1972, two years after the Penn Central had filed for reorganization, we at the Department of Transportation had drafted a complete revision of Section 77. We did not

[1] Conrail (Consolidated Rail Corporation) is a freight railroad, but it also operates intercity passenger trains for the account of Amtrak (National Railroad Passenger Corporation), which was established by Congress in 1970 to assume the passenger operations of any railroad that chose to get out of that business. Conrail also operates commuter services for the account of local transit agencies.

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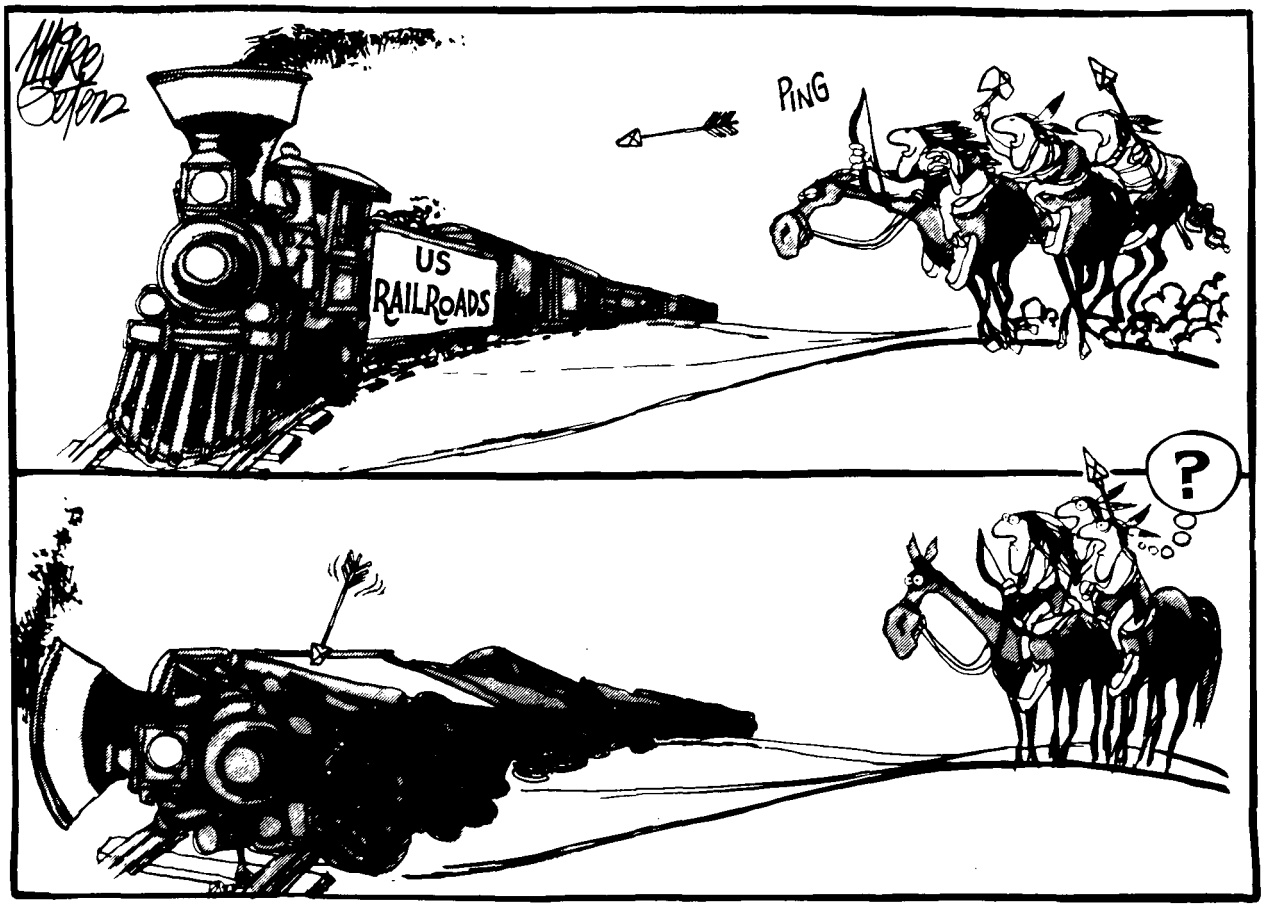
send it to the Congress, however, because it was already apparent that the problem in the Northeast was not to reorganize one railroad under any form of Section 77, but rather to reorganize several railroads simultaneously. Section 77 would not have permitted us or anyone to bring all the parties and issues together in a single forum, and even a revised Section 77 would have meant endless litigation during which critical elements of the national transportation system would have continued to deteriorate. So, instead of revising Section 77, the administration and the Congress developed the Regional Rail Reorganization Act of 1973—called the 3-R Act. The old Section 77, with its record of decade-long reorganizations, remains on the books.

The second lesson we learned—or relearned—is that railroad labor can and will call its own tune. The process that led to the 3-R Act was triggered by a one-day strike on February 8, 1973—a strike in response to the Penn Central's posting of some work-rule changes—and the labor protective provisions set forth in Title V of the act were pretty much written by railroad labor. Negotiators for the railroad brotherhoods did make certain concessions (such as granting management the right to relocate employees), but they held fast on the requirement that whatever new entity emerged from the reorganization process must start out with the labor contracts of the bankrupt lines.

The Penn Central's contracts were already more favorable for labor than most in the industry, largely because that was the price paid for labor's acquiescence to the 1968 merger of the Pennsylvania and the New York Central. It would be neither accurate nor fair, however, to suggest that labor costs were the sole cause of the Penn Central's insolvency. In their prescription for a successful reorganization, the reorganization trustees had identified two additional ailments—continued passenger service losses and unnecessary trackage—and had called for federal funds as the cure. (To complete the picture, we may note that other ob-



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servers included management as part of the problem.)

Title V did authorize federal financial assistance for displaced railroad employees. But so far only $180 million of the $250 million authorized in the 3-R Act have been committed for this purpose and Conrail has only 5,000 fewer employees than the 100,000-plus who worked on the bankrupt properties that Conrail acquired. Thus—as part of our second lesson—we learned that the problem of reducing labor costs is far more difficult than anticipated.

Even should Conrail now be able to consolidate and renegotiate those contracts (failing which it will never become profitable), clearly the requirement that Conrail assume the existing labor contracts sounded the death knell for any transfer of all but the smallest pieces of the bankrupt lines to solvent carriers. Since the 3-R Act assured the employees of the bankrupts that they would enjoy the benefits of their existing contracts or receive federal payments if displaced, their unions refused to accept any less favorable contracts with another railroad, even though the individual workers' jobs and existing pay scales would have been protected. Thus the requirement frustrated the Chessie System's acquisition of the Erie Lackawanna and the Southern Railway's acquisition of the Delmarva Peninsula properties of the Penn Central.

A third lesson we learned—or were reminded of — is that, in this arena, politics touches everything, usually with economically unsound results. Political pressures dictated aborting the strike in 1973, and political pressures dictated the size of the Conrail system. That system is larger than it should be (and is being kept larger than it should be) for political reasons. It is, in fact, too large to be viable. One of the main arguments for giving Conrail the entire $1.3 billion it is now requesting is to relieve the pressure on Conrail management to satisfy political interest groups. This has the marks of an ironical argument, or at least of adopting the "theory of the second best" with a vengeance. But undoubtedly it *is* better to give Conrail so large a sum than to give it less, which would leave it more vulnerable to continued political pressure and risk what it is given being improperly allocated for political reasons.

There has also been political pressure to assist railroads elsewhere in the country, and —given the need to obtain congressional support for spending billions of dollars on the railroads in the Northeast—it has not been possible to deny financial assistance to the Rock Island and the Missouri-Kansas-Texas. Thus, financing Conrail has necessarily meant supporting excess capacity elsewhere in the country.

Fourth—and here, for a change, is some good news—the reorganizations in the Northeast and the formation of Conrail proved that the courts can use a modernized bankruptcy law to reorganize railroads, and that they can do so expertly and within the short time limits set by such a law. One of the more fortunate occurrences in the Northeast rail reorganizations was the presence of John Fullam as the reorganization judge for the Penn Central and the selection of particularly qualified members for the Special Court (the new federal court established by the 3-R Act to oversee the formation of Conrail). But the fact that they are especially capable does not undercut—it may even support—the basic proposition that, given a workable statute, the federal judiciary is an invaluable mechanism for bringing order out of conflicting interests in a crisis of this sort.

Fifth, and this should not come as any surprise, we have again seen that government planning is less than perfect. Although the United States Railway Association (USRA, created by the 3-R Act to plan a solution to the problem of the eight bankrupt railroads in the Northeast) did an outstanding job, in my opinion, and although other government agencies (like the ICC and its Office of Public Counsel) made significant contributions, the fact remains that USRA's final system plan for Conrail was based on a number of assumptions about increased productivity and rehabilitation costs that have proven to be unrealistic. In other words, it has been demonstrated once again that government planning is not an especially satisfactory substitute for the decisions that emerge from the marketplace.

Sixth and last, we have been reminded that railroading is a precarious undertaking, with narrow—if any—margins of profitability. In recent times, the capabilities of highway and waterway freight and their federally provided advantages have jeopardized the viability of a national rail freight system, bringing to mind

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the story of how automobiles and airlines first jeopardized, then obliterated, the profitability of railway passenger service. Perhaps this points up the need for careful examination of federal financial assistance to the various modes of transport, as well as the need for some hard decisions to redress imbalances. In addition, we have recently seen—again—how vulnerable railroads are to the weather, to industry strikes, and to the state of the economy. And we have learned that catching up with maintenance and equipment problems is costly and difficult to budget accurately. Moreover, notwithstanding the efforts at regulatory reform culminating in the Railroad Revitalization and Regulatory Reform Act of 1976 (called the 4-R Act), we have observed the reluctance of both the ICC and the Congress to relax the heavy hand of regulation that has so often frustrated innovation and the efforts of managements to run their railroads profitably. Of course, as noted, we have also learned, or been reminded, that labor costs continue to be a significant barrier to profitable operation.

Caveats

Along with identifying the lessons we learned (or had confirmed) during the Northeast reorganizations, we should also take note of two important premises of the Northeast reorganizations. These premises were not so conclusively established by the results in the Northeast as to warrant calling them lessons, and they are, indeed, likely to be challenged as we come to deal with the Midwest.

We must recognize, for one thing, that the debates in 1973 and 1974 on how to solve the problem of the bankrupt railroads in the Northeast did *not* end for all time the specter of railroad nationalization. Because it was possible to reorganize most of the Northeast railroads into a new and more or less private-sector company,[2] the clamor for nationalization never rose above the annoyance level. The railroad brotherhoods' position was significant if not critical here. Among other things, the brotherhoods had studied the problems that nationalization had caused rail labor in the United Kingdom and were satisfied they could do better under reorganization than working for the government.

But if Conrail fails, the nationalization debate will resume. Moreover, if the railroad unions were to anticipate that a private-sector solution in the Midwest would differ substantially from the one in the Northeast—with adverse results for them—they might change their minds about nationalization, or at least show more interest in the idea during the political debate.

No more than it killed the nationalization idea did the Northeast reorganization kill for all time the idea of having the government take over the railroad rights-of-way. There has already been renewed discussion of this concept, especially in New England, where there is noticeable support for a regional transportation authority's doing just that—if not for taking over the railroads in their entirety.

It is easy to see why some of the railroads there and elsewhere in the country would be attracted to such a scheme. A railroad that has on its books several hundred million dollars in rights-of-way, on which it is earning a minimal return (if any), would be delighted—even ecstatic—to exchange that asset for a like amount of negotiable federal notes. Indeed, the railroad might even be better off financially than it is now if it sold the property at a discount (though management and the mortgagees would understandably start negotiations by asking at the least for the book value of the assets or even for their replacement and assemblage values). As a part of the same scheme, management might seek to improve its operating statements by contracting with the government to maintain the rights-of-way on a cost-plus basis. The government would then be underwriting something that the railroad should be doing now anyway, but often does not have the money to do.

In my opinion, the government's taking over the rights-of-way would be most unfortunate. It would saddle taxpayers with enormous acquisition and maintenance costs, frustrate any further improvement in the productivity of the national system by rationalization

[2] Conrail is a Pennsylvania corporation whose common stock is owned by the estates of the bankrupt railroads in proportion to the relative value of the assets they transferred to Conrail. The federal government's investment is reflected by debentures and preferred stock. The goal is to have Conrail retire the government debt and preferred stock out of earnings.

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and reduction of labor costs (there no longer being a profit motive in that aspect of the operation), and put the government into competition with other private-sector transportation —including other railroads if it acquired only the rights-of-way of the bankrupt lines. There would also be the problem of compensating local governments for the railroad properties taken off the local tax rolls. But Conrail's failure, or even an effort on Conrail's part to abandon unprofitable lines, would be likely to rekindle the interest in government ownership of the roadbeds—"just like the highways. . . ."

The Midwest Is Different

Before we try to apply in the Midwest what we have learned in the Northeast, we should look briefly at the principal differences between the two situations. I see four.

In the Midwest there is substantially more duplication of mainline capacity and probably an even larger percentage of surplus trackage (or trackage "available for subsidy," to use the USRA euphemism) than was the case in the Northeast. In the language of the economists, the opportunities for disinvestment are greater. And, perhaps more significant, there will be less justification in the Midwest for pressure from politicians to retain every inch of track inasmuch as there should be less loss of service per mile of disinvestment, whether through abandonment or through downgrading of mainlines to branch lines. (By this apparently naive comment, I do not mean that the political pressure will be any lower, only that its justification is less.)

In addition, none of the railroads in the Midwest is essential to a national system, as the Penn Central might have been said to be. Indeed there does not appear to be a compelling need to preserve any of the individual companies in the Midwest as independent entities.

Moreover, there is enough local and "bridge" traffic throughout the Midwest to make railroading profitable for a system burdened by less duplication. This statement assumes, of course, that a national railroad system is itself viable. Even if it is not, the Midwest still differs from the Northeast, where there was (and still is) some feeling that it is simply not possible to operate a railroad profitably east of Pittsburgh (or east of the Hudson, depending on one's expert).

Last, because of the potential profit, there undoubtedly are willing buyers for the viable segments of the Midwest lines, which was not the case for lines in the Northeast. When former Secretary of Transportation William Coleman attempted to solve the problem in the Northeast by inviting the Chessie and the Norfolk & Western each to take half of the properties of the bankrupt lines, the two managements asked for substantial federal financial assistance and even indemnification against losses as conditions for the takeover. Part of their reluctance was attributable to the enormity of the undertaking, which Conrail's experience now proves was a justifiable concern. But the basic problem was uncertain profitability. Even the relatively small acquisitions which the Chessie and the Southern sought to negotiate were only marginally attractive, and their attractiveness was dissipated by the unions' insistence on preserving their rights under the Erie Lackawanna and Penn Central contracts. In contrast, there should be in the Midwest a number of profitable bite-size consolidations available to well-heeled carriers interested in market extensions.

Applying the Lessons

How then do we apply what we have learned in the Northeast to this Midwest situation? I suggest the following conclusions.

First, a Conrail solution is not the right answer. Although several railroad officials have recommended consolidation with government assistance—"Farmrail" is one such scheme—I believe that we should avoid undertaking another government planning process and bringing about another collective reorganization, calculated to raise out of the ashes a brand new phoenix financed with federal funds. Such a process is less efficient than the marketplace, more vulnerable to political pressures, and unnecessarily expensive. Moreover, consolidating the viable elements of the Midwest railroads into a *single* new entity would both eliminate desirable competition and block the possibility of hooking the useful parts of the Midwest railroads to solvent railroads operating in other regions.

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Second, the federal government must resist pressures to bolster the bankrupt lines unless the bolstering will accelerate rationalizing the railroad structure in the Midwest. Existing federal financial assistance programs are intended for catching up on maintenance and otherwise improving those parts of the system that would be essential in any restructuring—for preserving and improving the national system as a whole as well as for aiding a particular railroad. But when the property belongs to a bankrupt line, the infusion of funds is likely merely to prolong the reorganization process and delay rationalization. The federal financial assistance provisions of the 4-R Act—the authority to guarantee loans and even for the federal government to purchase preferred (but subordinated) stock of the railroads—should be used in the Midwest as incentives for private-sector restructuring of the system. This does not mean shotgun marriages of insolvent or faltering railroads; it means preserving potentially viable pieces of a railroad for a while, lest they lose their attractiveness to solvent railroads.

Third, Section 77 must be replaced with a bankruptcy statute that will permit the courts to achieve reasonably rapid results, a statute that does not divide the critical authority between the ICC and the federal courts. There is a need for simplification and clarification of the court's authority and, ideally, for specific time limits in the statute. The courts should be able to authorize transfer or abandonment of property more easily than they now can. For example, they should have more leeway to permit property transfers before a plan is finally approved, rather than have to wait until the reorganization process is completed. At present such transfers can be frustrated by the argument that the property could be important to the surviving company. And certainly the option of merging with other railroads must be made more feasible than it is under Section 77. The revision of the Bankruptcy Act passed by the House of Representatives early in 1978 (H.R. 8200) would be a significant improvement over Section 77.

Last—and, in fact, part of the previous point but sufficiently important to note separately—some provision must be made, either in the Bankruptcy Act or in a companion statute, for federal financial assistance to railroad employees who lose their jobs or are relocated as a result of a reorganization. Subsection 77(n) of the Bankruptcy Act now continues existing collective bargaining agreements, and Section 1167 of H.R. 8200 would prevent the trustees and court from meddling with existing labor agreements except in accordance with Section 6 of the Railway Labor Act. Unless we have a statute similar to the labor protective provisions of the 3-R Act to cushion the impact of a reorganization on labor, it is unreasonable to expect that the spaghetti in the Midwest can be rationalized and sufficient disinvestment achieved.

Some of the nation's stronger railroads have been able to keep their systems lean and profitable by making substantial cash settlements to employees displaced by abandonments. But the bankrupt railroads in the Midwest are not in any position to do that, and the solvent railroads that might be tempted to acquire some of the bankrupts' properties could lose interest if they had to assume excessive labor costs, or even labor agreements inconsistent with their own. The same forces that kept the Chessie and the Southern from making any substantial contribution to the solution in the Northeast would deter the strong and solvent railroads of the West and the South from playing the role in the Midwest that would best serve the needs of the national transportation system.

The federal government would actually save money if it could handle the excess labor problem directly rather than indirectly. If the government cannot directly compensate workers who would be displaced, it will end up either financing the marginal or bankrupt railroads so that they can hobble along and fix up unneeded properties, or compensating the solvent railroads for the unnecessary labor costs involved in acquiring properties from the estate of a bankrupt railroad—or both.

Each of these four suggestions has been stimulated by the lessons that I for one learned from the Northeast reorganization. If those are indeed the lessons we should have learned, the principal issue is whether the administration and the Congress will have the political courage to apply them—to let the marketplace do the planning and to use federal funds to achieve a viable national system whose capacity (and therefore maintenance cost) is commensurate with the demand for rail service. ■

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HOBBLING COAL– OR HOW TO SERVE TWO

Richard L. Gordon

WHETHER government intervention has helped or hindered the coal industry, not even the government knows for sure. In a 1977 appraisal of the state of the industry, the General Accounting Office could not determine what the overall effects of public coal policy have been. Here I review that policy and suggest that its net long-term effect on coal production is probably negative (long term being defined as a decade or more). During that long a term, if serious barriers to the use of coal should increase, U.S. energy problems could be exacerbated.

Current policies restraining coal use were designed to attain legitimate social objectives. While we cannot hope to determine in the brief scope of this article whether the socially optimum level of controls has been reached (or exceeded), there is considerable reason to believe that none of the social objectives has been well served. Indeed, it will be truly a remarkable coincidence if the controls outlined here effectively contribute to any of their intended goals. I expect us to endure the worst of all possible worlds—inadequate attainment of our objectives at excessive cost.

Policy-Making for Energy

It is a truism that politically powerful groups have disproportionate influence on actions affecting their interests. What is not generally recognized is that the balance among interest groups in the field of energy policy-making has changed substantially in the last decade or two. The effectiveness of consumer and environmental groups has increased, while the ability of energy producers to influence decisions has greatly diminished. In fact, the strength of producers is now so eroded that although the coal industry still has some supporters strategically placed, even the previously favored, small petroleum producers have lost much of their political influence.

If the energy debates have added anything to what we already knew, it is the depressing fact that it is difficult for pressure groups to have a truly broad viewpoint, even when they are concerned with something as critical and all-encompassing as the environment. Consumerists and environmentalists have imitated other lobbyists in making extreme demands—though, to be sure, some claim their extremism is merely a matter of tactics, an attempt to lay the groundwork for advantageous compromises. It is not at all evident that so sanguine an appraisal is valid. At the very least, consumer and environmental groups have important intrinsic advantages over their corporate opponents. Public virtue is more appealing than commercial gain, and, for that reason if for no other, those purporting to speak for the common good should not need to be as strident as other interest groups. Moreover, there are questions about how well these groups perceive and promote the common good and about their willingness to compromise. By now, indeed, concerns over the elitist nature of environmental and consumer groups have become quite familiar. So also have suspicions that environmentalists are now more interested in claiming victory than in preserving the environment—and, further, that they tend to pre-

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MASTERS POORLY

fer unproven alternatives (such as massive conservation and solar energy) to producing more energy from known and proven resources.

For these reasons among others, it should not surprise us that energy policy-making is hindered by the presence of irreconcilable interests. There are those concerned about preventing environmental degradation. There are those who apparently believe that energy producers constitute some sort of evil conspiracy to be thwarted at almost all costs. There are those who are convinced that the world is running out of energy (or at least that available energy sources are located in countries that will restrict output so as to increase prices). There are the numerous U.S. energy producers who are themselves divided in their interests. To them, indeed, critics of the energy industries may seem less of a threat than other producers: coal mining companies fear oil and nuclear energy; the smaller firms fear the larger ones; specialists in extraction have interests different from the interests of those who process fuels.

Along with these irreconcilable interests come irreconcilable goals. Energy policy-makers insist on acting as though the goals can be reconciled and, indeed, as though they can all be attained painlessly. Any resolution of conflicts is delayed or avoided as much as possible. We have simultaneously proclaimed as objectives the need for lessening imports, for abating environmental damages, for protecting the public from high energy prices, for increasing competition, and for preventing industry dislocation and the dislocation of those the industries employ. Aside from questions that can be raised about the wisdom of some of these goals, we must recognize that they are in conflict. We cannot, for example, avoid some environmental degradation if we move toward significantly increasing domestic energy production, particularly of coal. We cannot keep down the price of domestically produced energy if we wish to expand its output.

It would seem then that the idea of a unified energy policy is, as it has been for at least twenty-five years, a chimera. Moreover, so long as a unified policy means developing a detailed long-term master plan like that in President Carter's national energy program, it will remain a chimera. We simply are not smart enough to make as many long-term decisions as that proposal would require; and, indeed, just designing the basic plan requires resolving more disputes than prudent politicians care to handle at once. If, on the other hand, coordination simply means making sensible trade-offs, this is quite feasible in principle but apparently impossible politically.

This article examines the effect upon one industry of our approach to energy decision-making. I conclude that the usual pattern has been to adopt measures that appear stringent and then to lessen their impact by allowing numerous offsets or escape clauses. The escapes may be provided in the statute or in subsequent statutes or regulations. This is, of course, a game that any number can play. It

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has proven almost equally feasible, for example, to nullify measures designed to promote coal use by imposing environmental conditions and to provide escape clauses in environmental regulations so that coal use can be promoted. While this way of making decisions is effective in reducing pressure on legislators, its impact on the attainment of national energy goals is far from beneficial. The difficult decisions are transferred either to the courts or to administrative agencies, bodies that are widely recognized to have their own severe problems with decision-making. The courts often have trouble in dealing effectively with complex technological and scientific issues. Administrative agencies do not always seek expert knowledge and may become overly insulated from broad public scrutiny.

Most of the policies discussed here were enacted in 1977 or are still being debated by Congress, so their effects are yet to occur. This article, thus, provides warning rather than review.

Turning to policy-making for coal, we may begin by listing those that critically affect coal use and coal production. The most publicized (and probably most influential) is increased regulation of the emission of air pollutants, especially sulfur oxides. This affects coal use. The principal issues affecting coal production are health and safety, the effects of mining on land use, and the leasing of federal coal rights. All of these issues affect coal mining generally, but health and safety issues are generally considered to be more a problem with underground mines, while land-use and leasing issues arise primarily in connection with surface mining. In any case, it is to alleviate the effects of pollution regulations on coal use (especially by utilities) and the effects of other regulations on coal production that new laws, including President Carter's energy program, have been designed.

Regulatory Problems in Coal Use: Air Pollution Control

The policy for sulfur dioxide emission control is not only the most important policy affecting coal, but probably the most complex. Two types of complexities may be distinguished. First, many different groups have a stake in and have influenced the policy adopted, both in form and substance. Second, the policy itself has become increasingly convoluted.

The groups include the actual policy-makers, the lobbyists for controls (mostly environmentalists), and the coal-using industries affected. The second of these groups needs little treatment, its success being by now familiar. In contrast, the policy-makers within our intricate regulatory structure and the companies responding to that structure merit fuller review. The principal policy-makers have been the Congress, the Environmental Protection Agency (EPA), and the state governments. (A fourth group—Indian tribes—also has been given some authority.) EPA has naturally pushed vigorously to ensure compliance with congressionally set air-pollution control objectives (although at one point in the 1970s, it is true, it did suggest that the states stop trying to comply more rapidly than necessary with federal requirements). This tendency towards as much vigor as possible suggests that EPA tends to give more weight to the views of its environmentalist supporters than to the views of others.

Coal-using firms have frequently sought relief in the courts and, though the enforcers have ultimately prevailed, the firms have at least won delays in enforcement. In Ohio, for example, when the state pollution control agency was unwilling to impose restrictions as stringent as EPA believed were required, EPA (in 1975) imposed federal restrictions. Several Ohio electric utilities took the matter to court, and the implementation of the restrictions is being delayed while the litigation between those utilities and EPA continues. In the same way a number of utilities won temporary relief from EPA's pressure to use stack gas-scrubbers (discussed below) when district courts found the scrubbers not technologically or economically feasible. Subsequently (in 1976), on appeal, the Supreme Court decided that, since the law was intended to *force* technological developments, feasibility was not germane.

Congressional action on controlling air pollution by coal users has involved the kinds of political conflicts that would be expected. Various senators and representatives compete to assert or maintain a dominant role over policy, and members from coal states try to find ways around the regulations. A blatant example of local protectionism came in the provision of the

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1977 Clean Air Amendments that allows states or the federal government to require the maximum possible use of local coal if serious damage to the local economy would thereby be avoided. Either could initiate the action, but the federal government must concur with a state request. In early 1978 the states of Illinois and Ohio were trying to use this provision to prevent local electric utilities from shifting to western coals.

When policy-makers impose goals that seem unreasonable to the industries affected and provide no credible incentives for compliance, it is improbable that the goals will be met. Managers recognize, at least subconsciously, that if their companies' products are essential, extensions will be granted to permit continued operation, even if air pollution regulations are being violated. This seems a powerful incentive for dilatory behavior and apparently helps produce the present complex pattern of stringent goals hedged with numerous escape clauses.

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Sulfur oxide control. To gain some insight into the problem, let us look first at sulfur oxide control policy. At present, EPA establishes the maximum allowable average annual concentration of pollutants in the atmosphere and the deviation (from the annual norm) allowed on any one day—even perhaps in any three- or, indeed, one-hour period. In addition, EPA imposes limits on the increases in pollution allowed in areas with air already significantly cleaner than required by the basic standards. This controlled-increase policy, called "prevention of significant degradation," came into the enforcement process through a court interpretation of the statement in the Clean Air Act that air quality should be preserved. Lacking precise legal guidelines, EPA had difficulty developing workable rules to "prevent significant degradation" and the Congress, in the 1977 Clear Air Amendments, sought to make things easier by establishing rules of nondegradation.

The new rules are based on concepts developed by EPA. The 1977 amendments establish three classes of strictness for pollution control, into which classes all regions or areas are to be placed. All land previously subject to the strictest requirements (including pre-existing national parks exceeding 6,000 acres in area) must be placed in Class I, the strictest class. Others (such as new national parks exceeding 10,000 acres in area) may be placed in either Class I or Class II. All other lands are to be placed initially in Class II, though the governors of the states involved may petition the federal government for up- or down-grading. The 1977 amendments also require more stringent rules for areas not in compliance with air quality regulations than for those that are: new facilities are not allowed in noncompliance areas unless an area can demonstrate that it has tried vigorously to comply or that the facility is vitally needed. In addition to these rules governing overall atmospheric concentrations, specific limits (based on technical feasibility) are imposed on individual facilities. Given the different bases of these various rules, it is unclear whether they will be compatible.

Until 1977, the emission rules for sulfur oxides had required new facilities burning more than 250 million Btu/hour in fuel to limit their emissions to 1.2 pounds of sulfur oxides per million Btu burned.[1] This standard could be met by using coal naturally low in sulfur content, by cleaning the coal to acceptable levels before combustion, or by using devices called stack gas-scrubbers that capture the sulfur oxides after the fuel is burned and thus prevent their discharge. In practice, precombustion cleaning has not been feasible, so that until 1977 the choice was between naturally low-sulfur coal and scrubbers. In the 1977 amendments, the option of using naturally low-sulfur coal was removed by introduction of the concept of the "best available control technology" (BACT)—a requirement that technically feasi-

[1] New facilities are those whose planning was begun after the rules were promulgated in 1971. But the *New York Times* (October 27, 1977) reported that EPA was defining new sources as those started after March 1978, when the implementation plan was expected to be complete, although members of Congress were quoted as thinking that the date the act passed should be the cutoff point. In any case, we now have two vintages of new sources—those covered by the 1971 rules and those covered by the implementation of the 1977 Clean Air Amendments.

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ble sulfur removal technologies be employed to the maximum possible extent. EPA initially said it would issue detailed rules in early 1978, but, as of mid-June, these rules had not appeared. EPA officials have said that the rules will combine minimum sulfur removal (probably around 90 percent) and maximum emission (probably about 1.2 pounds of sulfur oxide per million Btu burned). Such rules would both force the use of control techniques and prevent the resort to coal so high in sulfur that, even with treatment, there would be more pollution than before.

It may be asked why the BACT requirements were instituted and what is expected from substituting scrubbed high-sulfur coal for natural low-sulfur coal. BACT supporters seem to have hoped that both requirements would prevent a shift from eastern to western coal—a desirable objective, in their view, either because the shift would plunge Appalachia into still greater poverty than it now suffers or because it would lead to western strip-mining. A better rationale would be that BACT would produce a needed reduction in pollution. Given economic growth, there will be new sources of pollution and if the old standards were retained, total pollution would increase—possibly to undesirable levels. BACT could prevent such an increase. But this rationale would be more valid if BACT rules concentrated on emission rates rather than on rates of sulfur removal.

Even the imperfect models now used for projecting coal industry production patterns show that BACT slows rather than eliminates the growth of western coal use. Growth, though slowed, continues because of the growth of western markets. Such displacement of western coal as is projected generally benefits coal producers in the Midwest more than those in Appalachia. The model-builders believe that resource depletion has seriously eroded Appalachia's ability to expand its production to such an extent that the efforts of local politicians to aid the region's coal industry will have little impact. The models clearly were designed to determine what is readily determinable (the maximum benefits of BACT to eastern coals), and while they should be adjusted on the basis of more realistic assumptions, as it is, they still show little benefit to Appalachia. The difficulty is that no models can adequately handle two problems that are of critical importance. First, BACT offers a powerful incentive for shifting from coal to nuclear power. Conventional modeling approaches base the choice of energy sources on least-cost considerations and produce very high estimates of nuclear construction—so high the modelers doubt whether they are politically feasible. Second, there is no way of determining whether the production problems discussed below will cause eastern mining costs to rise so much that they outweigh the effects produced by the BACT requirement.

The state of scrubber technology. BACT is a curious effort to promote a controversial approach to sulfur oxide control in the face of evidence suggesting that stack gas-scrubbers may not be as effective as their advocates contend. Let us review the evidence. EPA receives from PEDCo Environmental, a research consultant, bimonthly reports on scrubber utilization that include, along with summary data, detailed operating histories of scrubbers actually in place. Scrubber advocates tend to report the summary data and ignore the histories. The summaries show a growing number of "operational" scrubbers (thirty-one as of January 1978), but the details make it clear that PEDCo uses a generous definition of "operational." Units are added to the operational category when test operations begin. No distinction is made among units that are operable, those that are out of commission, and those that fail to remove the required amount of sulfur.

Most of the successful units are engaged in mild scrubbing (50 to 60 percent removal) of sulfur oxides from *low*-sulfur coal. Those successes that have occurred in scrubbing *high*-sulfur coal appear to have come at high cost. Extra units have been installed so that frequent cleaning can occur without the plants being put out of service. (The cleaning is necessary because the units quickly become clogged and corroded.) Long shakedowns are often required to make the scrubbers operational, and even with the shakedowns, frequent outages seem to occur. Finally, since scrubbers capture the sulfur oxides in some absorbent such as limestone, problems arise in disposing of the resultant sludge. In short, scrubbers create cost, reliability, and waste-disposal problems.

How, then, did the devotion to scrubbers arise? The initial liking is easy to explain. Pol-

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icy-makers eagerly embraced the arguments of the equipment manufacturers and the coal industry (especially the high-sulfur eastern coal industry) that scrubbers were a cheap solution to the problems of air quality, providing rapid results and low cost while maintaining existing regional production patterns. However, the advocates of scrubbers failed to anticipate the difficulties that arose.

It is often charged that electric utilities "did not try hard enough" to make scrubbers work. Accusations of this sort are too vague to permit reasoned evaluation. However it can be argued that public policy was poorly designed to stimulate vigorous scrubber development. The federal government failed to adopt effective incentives to encourage compliance (such as an emission tax) or to finance scrubber development, and the utility industry had good reason to expect that failure to perfect scrubber technology would simply lead to extended compliance deadlines.

The refusal to back off from scrubbers can be attributed to the interaction of three quite different forces—the usual reluctance of politicians to confess error, the pressures of coal-state legislators to protect local coal, and the desires of environmentalists to limit the development (strip-mining) of low-sulfur western coal. These efforts having failed to stop a shift to western coal, the current justification for BACT has become, as we noted, that it will *slow* this shift. This faith in BACT may, of course, be equally unjustified.

. . . the history of sulfur oxide control strategy to date has involved the setting of goals and the subsequent backing away from them—which is what happens when goals are irreconcilable.

Goals and escape clauses. In any case, the history of sulfur oxide control strategy to date has involved the setting of goals and the subsequent backing away from them—which is what happens when goals are irreconcilable. Where we are heading cannot be told with certainty. However, the fact that several proposed new coal-burning power plants are having difficulties securing approval on environmental grounds is suggestive. A particularly dramatic example is provided by the problems of developing coal-fired plants to serve California.

Up until now, the emphasis for California's power developers has been on seeking sites outside the state where air pollution regulations are less strict and then transmitting the power into the state. Plants have been built in Arizona, Nevada, and New Mexico, and the last one planned — the Kaiparowits plant — was slated for southern Utah. But in 1973, with environmental objections having grown quite substantial, Secretary of the Interior Rogers Morton indicated he would not approve the plant. Extensive further efforts were made, and in early 1976, the Interior Department released a final environmental impact statement, with a decision expected shortly thereafter. Before this decision could be reached (or at least before it could be promulgated), the participating utilities canceled the project on the grounds that regulatory uncertainties made it too risky. Another group of utilities has proposed an alternative plant in southern Utah, but similar regulatory problems have arisen. Moreover, backers of the proposed first coal-fired plant in Idaho have also been unsuccessful in finding an acceptable site. It will be interesting to see whether the suggestions that coal plants instead of nuclear units be built in California and Maine will ever come to fruition.

Numerous escape clauses in the Clean Air Amendments could delay attainment of the stated goals. It seems safe to conclude that construction of coal-fired power plants is beginning to involve lead times comparable to those already plaguing nuclear power. The question is whether these constraints will cause the inadequate capacity expansion so widely feared by the electric utility industry.[2] What expansion rate the industry requires and what the delays will be cannot be foretold, but it is highly improbable that the required rate will be achieved and the delays held to a minimum. Moreover, it is even less clear what will happen for non-utility users of coal. Indeed, we have almost no idea about the economics of coal use by manufacturing plants under BACT. But what is abundantly clear is that existing policies conflict with the (alleged) goal of greatly encouraging coal use.

[2] Inadequacy is, like an energy gap, the layman's imperfect description of an excess demand created by price controls.

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Regulatory Problems in Coal Production

The major threat to coal production has been the sharp increase (probably in the neighborhood of 10 percent per year in constant dollars) in underground mining costs in the eastern United States.[3] This increase has its origins in both regulatory and market influences. The most important influence has been a radical change in labor market conditions. The pool of workers trapped in the coal industry as jobs disappeared (because of falling total output and rising output per worker) itself disappeared some time ago.

Safety and health. In recent years there has been rising total output and falling output per worker (along with retirements), with the result that the coal industry has turned to recruiting younger and less docile workers who demand greater compensation for, or protection from, work hazards. Their demands have resulted in a stricter Federal Coal Mine Health and Safety Act (passed in late 1969), tougher bargaining at the national level, and unilateral action through wildcat strikes at the local level. All of these increase production costs.

The primary but difficult question is whether there is a reasonable chance that cost increases will moderate. Presumably, once the industry has fully adjusted to new labor market conditions, no further direct labor-cost increases should be needed—unless the new conditions retard or eliminate productivity advances.

The 1969 act required changes in every aspect of mining deemed by Congress to affect health or safety. Clearly, the requirements for extra equipment and for devoting more time to health and safety work, as well as the more frequent interruptions of work by mine inspectors, could only increase costs. The magnitude of the act's effects is unknown, even to many of the coal companies affected, since few of them have tried to isolate those effects from other influences on costs. Work on the costs of the act being carried out under my direction at Penn State suggests that the act is the largest source of productivity decline, a conclusion consistent with the view that labor market conditions have had the major influence on costs, since labor market conditions created the act. Edward Denison's estimates of the impact (appearing in *Survey of Current Business*, January 1978) appear to be too large. He assumes that a 5 to 6 percent increase in output per man-day would have prevailed without the act. The observers of the mining industry with whom we have consulted tend to believe productivity growth prospects were far less favorable. In any event, whatever the relative importance of the various causes, rising costs are a serious threat to the competitive position of underground coal mines.

Two further problems affect underground coal production. First, the growing reach of environmental regulations in general has lengthened lead times for mine construction. Numerous permits must be obtained from both the agencies regulating mining and the various environmental authorities, such as those charged with water pollution control. Second, the 1977 Surface Mining Act requires control of the surface effects of underground mines as well as of strip mines.

Restrictions on land use. Obviously, the main effects of the 1977 mining act are on strip mines. Section 515b sets forth twenty-five strip-mine reclamation requirements, including requirements

- to "maximize" initial recovery so that a second disturbance of the surface to recover other seams is avoided,
- to restore land to a condition that allows a use at least as good as the use prior to mining, with extra effort required if the land is considered prime agricultural land,
- to restore land to the original contour, except where impractical,
- to stabilize areas so as to avoid erosion,
- to segregate and preserve the quality of topsoil or of a subsoil of better quality than the actual topsoil,
- to avoid disturbance of hydrologic balance with special emphasis upon alluvial valleys in the West (these being valleys where disruption of water flow would interfere with farming), and
- to revegetate the reclaimed land.

State governments are authorized to prohibit strip-mining on lands if it would produce specific hazards (such as increased chance of floods) or merely if it would be incompatible

[3] The estimate is derived by combining Charles J. Johnson's and my estimates that 1969 prices were in the 18–20 cents per million Btu range, viewing *Coal Week* listings of 1977 quotations for coal selling on long-term contracts, and deflating by the implicit deflator for the gross national product.

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with land use plans. The secretary of the interior is required to prohibit new mines in national parks and other classes of federal lands, is authorized to prohibit new mines on the basis of state criteria, and must consider private requests for prohibitions. The act requires that, in cases where federal coal rights were retained when the surface was sold, the surface owner must give written permission for mining. Moreover, if substantial opposition to strip-mining exists among surface owners, the secretary is authorized to prohibit the mining. Finally, to meet the objections of those states that had passed their own stringent laws and saw no need for the federal government to interfere with them the states are allowed to administer their laws if the programs involved are acceptable to the federal authorities.

Opinions of the 1977 Surface Mining Act obviously differ. In a study of a similar 1976 bill, ICF, Inc., noted that that bill would have had somewhat greater effects than existing state regulations, but warned of ambiguities that could be interpreted so as to produce even more severe effects. The coal industry, expecting the worst, has sued the Interior Department for allegedly adopting more severe interpretations of the 1977 act than it requires.

On its face, the 1977 act does seem set up to disrupt coal production. The introduction of the alluvial valley provision, the special treatment for prime agricultural land, and the protection for surface owners appear particularly likely to produce implementation problems. Moreover, Secretary of the Interior Andrus has displayed a clear desire to shift his department from its traditional role as promoter of industrial development to a new role of protector of the environment with all that this implies—including more stringent interpretations of environmental laws.

Land ownership. Other problems affecting western coal grow out of the complexities of land ownership patterns in the region. With the federal government the principal owner of coal rights, substantial difficulties arise simply from the need to contend with federal policies on the leasing and exploitation of government-owned coal. In addition, much of this federal "ownership" consists of mineral rights on lands for which the right to use the surface has been sold. The Surface Mining Act contains, as I mentioned, provisions requiring the consent of the surface owners before mining can proceed —creating a substantial likelihood of obstructionism.

Ownership of coal or coal rights is further fragmented by the long-standing "checkerboard" pattern of grants of land to railroads (so-called because the split between railroads and the federal government looks like a checkerboard when mapped), as well as by the fact that Indian tribes, the states, and other private parties also own coal rights. But the most pressing problem here seems to be difficulty in securing permission to exploit existing leases. Exploitation plans require environmental impact statements and federal approval. Unfortunately, the Bureau of Land Management, which has primary responsibility for approvals, is inadequately staffed to complete the necessary environmental impact statements with any degree of rapidity.

There is, in addition, a long-term problem in the combination of the moratorium on new leases that has prevailed since 1971 and the 1976 amendments to the leasing laws. The moratorium does allow leasing of limited tracts adjacent to previously leased land when these tracts are needed to permit optimal development of the property. However, the Interior Department has been quite dilatory in granting such leases.

The overall moratorium began because of concern that too few leases were being exploited. Delays in resuming leasing were the result of (among other things) a long gestation period for the environmental impact statement covering the overall leasing program (accompanied by Secretary Andrus's desire to reappraise leasing policy) and a still unsettled suit brought by environmental groups attacking the adequacy of the environmental impact statement. The 1976 leasing amendments require greater planning by the Interior Department, increased reporting by firms, and the development of leases within a decade. A federal task force has charted the net effect of all the regulations affecting coal leasing and, as far as I can tell (winding my way through the four gigantic charts, each of which more than covers a large desk), once leasing resumes, it will take a decade to move from setting up a lease sale to producing coal. Thus, both underground and surface mining face the same climate of restraints on expansion endured by users of coal.

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This obviously increases the likelihood that coal production goals will not be met.

Regulation and Offsetting Incentives

One could conclude, along with the 1977 report of the General Accounting Office, that restrictions on the coal industry will prevent the opening of enough new coal-mining capacity to meet even the billion-ton output level widely forecast for 1985, let alone exceed this level as President Carter has proposed. Certainly there is considerable doubt whether BACT will be able to reverse the shift to western coal—especially since surveys of coal industry expansion suggest a heavy concentration of new capacity in the West.

Given the prevailing long lead times, it may be difficult to make any radical change in immediate expansion plans. Even if there were sufficient time to shift emphasis back to eastern coal, it is not clear that the shift would be economically attractive. Continued sharp rises in eastern mining costs may erode the incentives provided by the imposition of BACT. Production of western coal may be sufficiently cheap to overcome the cost disadvantage of BACT. It *may* prove significantly cheaper to apply BACT to low-sulfur coals, and in any case, much of the western coal is destined for use in the Southwest, where transportation costs for eastern coal would be prohibitive. Moreover, it appears that the lead times for large new coal-based plants will no longer differ significantly from those for nuclear. In this case, electric utility managements —generally believing that, if time permits, it is cheaper to build nuclear plants—will do so. Thus, those who support policies designed to thwart western coal development may have helped bring about what they often consider to be much worse.

It was to offset the effects of all these policy measures that President Carter called for a program to encourage greater use of coal. The coal-use incentives in the proposed National Energy Act of 1977 are a complex set of prohibitions, taxes, and subsidies. The basic prohibitions are that new electric power plants and new large industrial boilers must use coal and that, after January 1, 1990, electric power plants should cease to use gas. A shift from gas to oil could be allowed only under special circumstances, and conversions to coal earlier than 1990 could be required if feasible. The tax and subsidy elements of the plan include imposing taxes on oil and gas use and then giving tax rebates equal to the amount of the investment made so that coal (or synthetic fuels from coal) could be used. Following the pattern criticized in this article, the plan would exempt many users from the rules.

The proposed tax system would involve several features. First, the oil tax would be different from the gas tax. Second, electric utilities would be treated differently from other industries. Third, the rates would be adjusted for inflation. (With inflation adjustments left out, the electric utility tax system would involve a flat 25 cents per million Btu tax on oil use after 1982, while other taxable oil users would pay a tax that started at 15 cents per million Btu in 1979 and rose in steps to 50 cents in 1985.) All these taxes would be raised at the same rate as the implicit deflator for the gross national product (a measure of the rate of change in prices in all sectors of the economy). The basic gas tax would be ultimately set at the difference (on a per-million-Btu-basis) between number-2 fuel-oil prices in the region and the consumer's actual cost of gas. Again, the taxes would be phased in. Electric utilities would not be covered until 1983 and, from 1983 to 1985,

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the tax for them would be 50 cents per million Btu below the level required in the basic formula; that reduction would fall to 25 cents in 1987 and 1988 and disappear in 1989. Other users would start being taxed in 1979 with a reduction set at $1.05 in 1979, falling to 40 cents in 1980 and then, more gradually, to 15 cents by 1984 and to zero (full tax) in 1985. The amount of oil and gas taxed for each user would vary with consumption. Those using less than 500 billion Btu would be exempt from the tax. The exempt amounts would be reduced for larger users, and those using 1.5 trillion Btu or more would pay the tax on all oil and gas used.

Whether anything resembling the President's bill ever will pass seems doubtful. The House-passed energy bill included prohibitions close to those proposed by the President, but the tax provisions were substantially altered. Essentially the same tax on oil was set for electric utilities. Large users of oil and gas as fuel for industrial boilers also were subjected to taxes roughly equal to those proposed by the President, but the House exempted more users and subjected others to lower taxes. A tax per million Btu starting (without inflation adjustment) at a maximum of 65 cents in 1983 and rising to 75 cents in 1985 was set for electric utility gas use. This last tax cannot raise costs of gas above the cost of fuel oil per million Btu.

The efficacy of these proposals for increasing coal use can be questioned. First, they were weakened in the House and further limited in the Senate. Second, the administration may have significantly underestimated the incentive needed to encourage coal use in the face of all the industry's difficulties. Third, good reason exists to suspect that additional restrictions on the production and use of coal will be imposed, since existing programs are likely to be made more stringent and since action might be taken in other areas—notably, air pollution control for nitrogen oxide, carbon dioxide, and trace elements.

Summary and Conclusions

I have argued here that the prospects for coal use have been hindered by growing restraints that have increased costs and lead times. The wisdom and the efficacy of President Carter's proposals to offset these hindrances remain in doubt.

One can dispute the wisdom on various levels. The most fundamental problem is the familiar one—that of embracing ambitious goals (in this case, for controlling the side effects of coal production and use), and then trying to add another (and complex) program to cushion the shock. If coal production and use are so undesirable that their costs should be raised, then offsetting stimuli seem unwise—which, of course, calls the whole proposal for increasing coal use into question. If controls have been overdone, it would be preferable to lessen the controls directly, rather than set up new controls. Given that the administration does not know the full impact of the controls now being imposed on coal (nor does anyone else), the efficacy of its incentive program also remains in doubt. In addition, there may be better ways (such as deregulating oil and gas) to solve our energy problems.

The risks of failure are serious. Not developing coal production as expected will require costly emergency replacements. Certainly our current knowledge is inadequate to indicate whether the controls on coal produce benefits commensurate with their costs. The main economic conclusion reached here on the coal industry itself is that the costs of restricting coal production and use have been underestimated, with the expenses of complying with new regulations inadequately considered. Beyond this, because we are insufficiently aware of how great is the conflict between proposals for expanding coal use and policies that hobble coal, we are not making adequate preparations to resolve that conflict.

Looking at the coal industry as an example of the problems of energy regulation in general, we see a graphic illustration of tangled policy conflicts. The interest groups—here, coal users (mostly utilities), coal producers, and environmentalists—have interacted (one might say, fought) in such a way as to produce highly complex and highly inconsistent policies, aiming at highly inconsistent goals. Certainly this was predictable on the basis of what has happened in earlier energy regulation. But that it should have happened in an industry providing a form of energy hailed as the hope of the (short-run) future and, moreover, have happened during a highly publicized national effort to rationalize our energy policy bodes ill for both energy rationalization and national energy policy. ■

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The Federal Election Commission

Government Astride the Political Process

John R. Bolton

THE FEDERAL ELECTION Commission (FEC) has been on the watch for "corruption or the appearance of corruption" in federal election campaigns for some three years now —long enough so that we can begin to assess its performance. This assessment is especially important for at least two reasons. First, the Federal Election Campaign Act Amendments of 1974 (under which the commission was established) are attacked as an "Incumbents' Protection Act" and, if the attack is justified, thus represent an interesting extreme case of regulation for the benefit of those being regulated.

Second, campaign speech comes under the free speech guarantees of the First Amendment, and a regulatory commission whose duties impinge upon First Amendment rights should be subjected to greater scrutiny than a regulatory commission whose duties involve (say) railroad rate-setting. The Supreme Court has consistently limited the discretionary authority of government agencies whenever that authority might "chill," or deter, citizens from exercising their First Amendment rights. By contrast, agencies concerned with economic regulation have been granted broad latitude. To see the reason for the difference we need only note that Mr. Justice Frankfurter, while staunchly denying the "preferred position" of First Amendment rights, found such rights to be "the indispensable conditions" of an open society and deserving of a "respect lacking when appeal is made to liberties which derive merely from shifting economic arrangements" (*Kovacs* v. *Cooper*, 1949).[1] Because the FEC is concerned with more than the "shifting economic arrangements" handled by the ICC, its actions should be more carefully restrained.

The FEC, established in 1975, has the power (upon the request of certain persons and committees) to issue advisory opinions, to promulgate regulations, and to set federal policy for campaigns whose outcome is election (or nomination for election) to the presidency, the Senate, or the House of Representatives. In addition, it has the power (and responsibility) to investigate complaints filed with it and to conduct investigations in the absence of a complaint when it has reason to believe that the Federal Election Campaign Act has been violated. If the alleged offender does not disprove the charge or enter into a "conciliation agreement," the commission can institute civil suits and seek declaratory relief and civil fines.

This authority is conferred by the 1974 amendments to the Federal Election Campaign Act. The act's purposes, as deduced from the legislative record by the Supreme Court in *Buckley* v. *Valeo* (1976), are to prevent "corruption and the appearance of corruption" in the financing of candidacies for federal office. Yet, much of the act and much of what the FEC has done are unrelated to these purposes.

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[1] I assume, for purposes of this article, the "preferred position" of the First Amendment within the framework of constitutional jurisprudence. Whether it deserves such a position and, if it does not, whether there should be more regulation of the marketplace for ideas or less regulation of the marketplace for goods and services, are questions I leave for another day.

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In discussing how the Federal Election Campaign Act has operated, it is sometimes difficult to distinguish between the deficiencies of the statute on the one hand and the FEC's excessive discretion on the other. Indeed, in many cases, the problems I wish to address are caused by a third factor—the impossibility of fair and equitable regulation of campaign financing under *any* statute as administered by *any* commission. In what follows I discuss each of these three factors, largely by reference to examples of commission action that, as a lawyer who practices before the FEC, I believe best illustrate the commission's problems. If the examples are among the more egregious that could be cited, they nonetheless seem to typify the commission's general approach to regulation. Moreover, they pertain to the areas of the law that should be of greatest concern if the protections of the First Amendment are to apply fully in partisan politics.

Problems with the Statute

The unfairness of the campaign finance law comes through in many ways. As I have argued elsewhere, its low contribution limits favor incumbents while discriminating against challengers, and its burdensome disclosure requirements needlessly complicate campaigns, a matter of more importance to the inexperienced challengers than the experienced incumbents (*Vanderbilt Law Review*, November 1976). But even more important than its favoring incumbents, the law treads dangerously near to favoring government in general at the expense of First Amendment rights.

The Legislative Veto. Fundamental to any analysis of the FEC is the provision in the statute that gives either house of the Congress the right to veto proposed FEC regulations. The Congress retains, in other words, the final decision over whether the agency can implement its proposals. Critics of the use of the legislative veto in the campaign finance law charge that it provides incumbents with a way to dominate the process by which the statute is administered and enforced. As the American Civil Liberties Union put it, the statute is "like a football game where the home team makes up all the rules. . . ."

As we shall see, Congress proved the correctness of this charge by using its veto to reject the first two sets of regulations proposed by the commission. Since then, the FEC has danced gingerly around any question involving incumbents. In a statute designed to enhance

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"Hit him again with the deodorant!"

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the integrity of the electoral process, there is simply no place for the legislative veto—a provision that can only help the "ins" at the expense of the "outs."

Vagueness in the Statute. A second basic problem with the statute is that it is so poorly drafted that even if the FEC were reluctant to use its discretion (which it plainly is not), the statute would virtually compel unguided bureaucratic choices in important matters that should have been reserved for formal legislative judgment. Indeed, there is so much vagueness and uncertainty that agency responses to critical questions—left unanswered in the statute—can determine whether a candidate spends six years in the New Senate Office Building or one year in Lewisburg. It cannot be too heavily stressed that, because "First Amendment freedoms need breathing space to survive, government may regulate in the area only with narrow specificity" (*NAACP* v. *Button,* 1963). If the Federal Election Campaign Act is narrowly specific, I for one would doubt that any act could be considered vague.

At the heart of the vagueness problem lie two terms central to almost every provision of the act—"contribution" and "expenditure." The FEC's varying treatment of these terms offers a classic example of the excessive discretion granted under the statute.[2]

Following the Supreme Court's decision in *Buckley* v. *Valeo* (which upheld the statute's ceilings on campaign contributions but found its limits on campaign expenditures unconstitutional), the question arose whether contributions to "independent expenditure committees" (committees making independent expenditures for or against candidates, which means expenditures not made in coordination with a candidate's campaign) were subject to contribution limits. Many believed that they were not. Their argument was that the Supreme Court had sustained the constitutionality of contribution limits only because of the supposed compelling governmental interest in preventing corruption and the appearance of corruption, and had struck down limits on independent expenditures on the grounds that these expenditures did not have the same potential for corrupting or appearing to do so. Insofar as the potential for corruption was concerned, therefore, contributions to independent groups were functionally the same as independent expenditures.

The commission did not see it that way. It first held that contributions to independent expenditure committees were subject to the same contribution limits that were applicable to any political committee—$5,000—regardless of its activities (draft response to Advisory Opinion Request [AOR] 1976-20). Later, however, the commission changed its mind. In the version of its opinion eventually adopted, it held that independent expenditure committees supporting only one candidate could not accept contributions in excess of $1,000. It further held that the amounts an individual had contributed directly to a candidate were chargeable against the $1,000 limit that individual might contribute to an independent committee also supporting that candidate. Thus, if someone gave $500 to a candidate, he could give no more than $500 to an independent committee whose only activity was to support this candidate. Not only is such a result illogical—the same person might contribute $1,000 directly to a candidate and then make *unlimited* independent expenditures—but it amply demonstrates what statutory vagueness can lead to. The commission completely reversed its position and severely limited the freedom of action of independent committees. The FEC's tergiversations would be entirely inexcusable were it not that it had no guidance whatsoever from the Congress in this area.

To give yet another example of statutory vagueness, the Federal Election Campaign Act treats any expenditure made in coordination with, or under the supervision of, a candidate and advocating that candidate's election (or his opponent's defeat) as a contribution to the candidate and therefore limited to $1,000 per individual. Should such an expenditure be made without the candidate's consent or without coordination with his campaign, it is an "independent expenditure" and can be made without any limit.

[2] The Supreme Court of Missouri recently declared unconstitutionally vague the definitions of "contribution" and "expenditure" contained in that state's election law (*Labor Educational and Political Club—Independent* v. *Danforth,* 1977). The Missouri statute used the same definition for both terms. Interestingly, the federal statute comes very close to doing the same thing—which suggests that a constitutional challenge on vagueness grounds might well be appropriate in its case also.

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Now, during a campaign any well-informed person can know a great deal about a candidate, his strengths and weaknesses, and how he hopes to get elected—without ever coming anywhere near the candidate or his staff. No one has yet suggested that such a person is disqualified from making independent expenditures. The FEC, however, has said that

> individuals in attendance at [a party] where a representative of [a] campaign appears and communicates information about campaign plans, projects or needs may have been precluded from making independent expenditures on [that] candidate's behalf. . . . [Opinion Request (O/R) #786]

This rule apparently applies even though a person reading the same information in a newspaper the next morning would in no way be precluded from making independent expenditures. Perhaps even more disturbing, the FEC's opinion does not state that an individual must have actually heard the information being imparted—only that he must have been present. The prospects this raises—in the context of actual enforcement proceedings—for detailed probing into the private lives of citizens are sobering at best.

Problems with the Commission

Enforcement Priorities. The commission devotes large amounts of its resources to pursuing the most trivial kinds of violations. It gives considerable attention, for instance, to the so-called non-filers—federal candidates who have failed to register with the commission, failed to file the proper disclosure reports, or failed to establish principal campaign committees, as required by the statute. To date, the commission has instituted over 100 civil suits against non-filers.

These candidates are typically third-party or independent candidates, or candidates seeking the nomination of one of the two major parties. They include no incumbents. Only a tiny minority of them win more than a minuscule share of the vote, and their expenses are typically trivial. The FEC has, for instance, instituted civil suits against members of the Socialist Workers party, the Prohibition party, La Raza Unida, and the Communist party. As former Senator McCarthy remarked about such suits:

> If you are waiting for an FEC investigation of the link between campaign contributions and the cargo preference bill or a check of bank loans to the Carter campaign, remember that the Commission is burdened with more important work.

Defenders of the commission's policy argue that proceeding against non-filers encourages "voluntary compliance." Moreover, if the commission does not institute proceedings, they say, the statute will fall into disuse as did its predecessor, the Corrupt Practices Act. One wonders, however, what kind of example the commission is setting when it proceeds against the least powerful and least popular federal candidates—when, in effect, it is prosecuting the widows and orphans of the political process.

It might be asked why the commission concentrates *any* of its resources on such candidates. In *Buckley*, the Supreme Court held that the compelling governmental interest that justified contribution limits was the prevention of corruption and the appearance of corruption—that is, the statute was designed to prevent the securing of any political *quid pro quos*. If a candidate does not hold public office—indeed, never had a serious chance of reaching that office—harassment will do nothing to prevent corruption. Defeated candidates (no matter who owns them) cannot affect government policy. They have no *quos* to exchange for any *quid*. If the commission is to have any comprehensive strategy, it should be the repeated and careful scrutiny of incumbents.[3] But that, of course, would send the commission straight into history's wastebasket.

Some Candidates Are More Equal Than Others. One consistent theme in commission pronouncements is that whenever the statute offers the option, the commission rules in favor of incumbents. This pattern is based on unhappy experiences of the FEC's childhood, against which it has been guarding ever since. The very first set of regulations it proposed provided for close regulation of, and limitations

[3]The FEC gives considerably more attention to presidential candidates receiving public subsidies than to congressional candidates, in large measure because of statutory requirements.

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on, congressional "office accounts." The Senate, making use of the legislative veto, promptly torpedoed those proposed regulations. As time passed, the commission made revision after revision to the regulations, in the course of which substantive limitations on the office accounts disappeared. Only disclosure now remains. In short, Congress got its way.

The FEC's files abound with similar results. For example, Congress provides funds (by legislative appropriation) for various partisan research groups whose output is available almost exclusively to incumbents. Challengers either have to rely on volunteer researchers or have to purchase such services. Nevertheless, the FEC found it permissible for incumbent members of Congress to use public funds in ways ultimately useful to their reelection efforts (Advisory Opinion [AO] 1976-34). If an employee of a corporation takes a leave of absence from his job to run for federal office and the corporation continues to pay his salary, the corporation has made an illegal contribution (AO 1976-70). Yet when a member of Congress runs for reelection, his salary is paid by the government and lawfully available to him to spend on his campaign. Thus, while incumbents have control over their own incomes, the FEC is busily restricting what challengers can do with theirs.

There is undoubtedly considerable pro-incumbent bias inhering in the statute itself. But the FEC's performance has made the situation even worse.

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Enforcement Procedures. Unfortunately, the adverse effects of commission activities are not felt only when the FEC brings civil litigation in federal court. Enforcement proceedings before the commission sometimes verge on the Kafkaesque. Although the campaign act, reflecting some sensitivity to First Amendment concerns, requires that respondents in these proceedings be given a "reasonable opportunity to demonstrate that no action should be taken" against them, in practice that requirement provides precious little protection. By its actions, the commission has effectively vitiated the intended procedure.

The person involved typically learns that an enforcement action has been commenced against him or her by receiving a letter signed by the commission's general counsel. If the investigation was triggered by a complaint, a copy of the complaint should be included with the notification (although this does not always happen). The notification letter states that the commission has found "reason to believe" that a violation of the statute has occurred. Ascertaining what the alleged violation is supposed to be, however, is not so easy as one might think. The supposed offense is described in the most cursory language, often merely tracking the words of the statute. In the course of an investigation, a respondent may try repeatedly to find out the exact nature of his or her alleged offense, all to no avail.

As respondents cope with interrogatories, notices of depositions, and requests for production of documents that pour out of the commission, they remain in the dark as to what information the commission has turned up from other sources, how much of it is true, half-true, or completely false, or what bearing it has on the compliance action. The discovery activity proceeds at an erratic pace, sometimes interrupted by months of silence, until the respondent is informed that the commission has found "reasonable cause to believe" that a violation has occurred. This finding moves the investigation into a new stage: either the commission and the respondent must enter into a "conciliation agreement" or the commission must decide whether to institute a civil suit seeking injunctive relief and possibly a civil fine.

The respondent's options at this stage are extremely limited. If he chooses to enter into a conciliation agreement, he must admit the alleged violation, probably pay a fine, and promise to comply with the statute. (Note that the commission has repeatedly refused to agree to the common "consent decree" approach, where the alleged violator neither admits nor denies the violation but promises not to engage in the prohibited activity in the future.) If he chooses instead to go to court, the question that has been pursued confidentially until this point

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will be pursued in public proceedings. Many respondents would prefer to have their admission of a violation buried in the commission's file (even though that file is available for public inspection and even though the fact of a violation may return to haunt them in later campaigns), rather than risk the publicity of proceedings in open court. In such circumstances, it should come as no surprise that, once again, the respondent has little chance to present a case.

The Federal Election Commission is—must be—different from other agencies, because it regulates political speech, not railroad rates.

Nowhere in these procedures can one find the required "reasonable opportunity to demonstrate that no action should be taken." Since the respondent usually cannot be certain what the alleged offense is, it is difficult to demonstrate that it did not occur. Even if fully aware of the supposed violation, the respondent cannot respond to evidence that is kept from him. Moreover, he risks making statements or revealing evidence that the commission can readily use against him. This risk is by no means trivial. Since the respondent does not know what facts the commission has or how it is interpreting them, the commission has considerable flexibility to shift its position in light of the arguments made by the subject of the investigation.

The commission's defenders are quick to point out that its procedures are not substantially different from those of other regulatory agencies. Even if that were true, it misses the critical point. The Federal Election Commission is—*must be*—different from other agencies, because it regulates political speech, not railroad rates. If the commission continues to operate in its present fashion for any substantial period, it must be assumed that the chilling effect of its actions on political speech will be more and more widely felt, though the most important adverse consequences of its actions will remain invisible: political activity that is stifled before it can take place will not be missed.

Inconsistency and Unreasoned Decisions. The FEC's advisory-opinion power appears, at first blush, to be a means of reducing the vagueness that permeates the statute. Unfortunately, exactly the opposite is true. The commission's advisory opinions have been almost a random walk through various possible outcomes.

Consider what happens when a candidate wants to tie his campaign to that of his party's candidate for President. Representative (now Mayor) Edward Koch of New York, running for reelection to Congress in 1976, had what would seem to be a relatively simple idea: why not manufacture some buttons that read "Carter-Mondale-Koch" and distribute them to his constituents? This was hardly a novel or potentially corrupt campaign tactic; nonetheless, the question whether to permit Representative Koch to distribute his buttons was a perplexing one for the FEC.

The problem arose because candidate Jimmy Carter had chosen to accept federal subsidies for his general election campaign. Accordingly, by the terms of the statute, private contributions to his campaign were not permitted. Were "Carter-Mondale-Koch" buttons forbidden contributions, or were they permissible "independent expenditures" by Representative Koch—that is, expenditures made by a person not under the control of or in coordination with the candidate supported or opposed? For weeks, the commission deliberated.

Finally the FEC decided that Representative Koch could use the buttons. But its opinion permitting the buttons to be used, a truly Delphic pronouncement, offered no explanation for the decision (Re: AOR 1976-78). The FEC later ruled similarly—without explanation—in a different case and permitted a congressional candidate to issue a brochure containing a picture of the presidential nominee of the candidate's party (Re: AOR 1976-82).

Next came the case of Representative Parren Mitchell of Maryland, also running for reelection to the House in 1976. He proposed to purchase a newspaper advertisement on behalf of his candidacy and to include in that advertisement pictures of the Democratic presidential and vice-presidential nominees and the Democratic Senate candidate in his state. Opined the FEC:

> It is clear that Mr. Mitchell's campaign cannot pay the entire cost for the described

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> advertisements, since a portion of such a payment would be necessarily regarded as an in-kind contribution to the Carter/Mondale ticket. . . . [Re: AOR 1976-93]

In its letter to Representative Mitchell the FEC made no mention of its two earlier opinions on the same subject. It did not distinguish those earlier decisions from the later one, it did not overrule them, and it plainly did not follow them.

Consider next what happens if a "public interest" group wishes to provide a campaign platform for some, but not all, of the candidates for a federal office. When the League of Women Voters' Education Fund offered to sponsor a series of debates between President Ford and Governor Carter, the FEC issued a "policy statement" on August 30, 1976, explaining the constraints imposed on the debates by the statute. That statement provided that the Education Fund's expenses would be treated neither as contributions to candidates Ford and Carter, nor as expenditures (independent or otherwise) on their behalf; moreover, those expenses would not need to be publicly reported or disclosed. Such a result would seem to indicate that the debates were simply not regulated by the statute. However, the policy statement went on to forbid the Education Fund from accepting direct corporate or union contributions earmarked for the debates. At the same time, the statement permitted such contributions in unlimited amounts from other sources (including corporate and union political action committees). The FEC adopted the restriction on direct corporate and union contributions for the debates despite its earlier acquiescence in an opinion by its general counsel permitting them for the League of Women Voters' debates among candidates for the Democratic presidential nomination.[4]

The FEC never explained its shift on this point. Its policy statement did not address the question whether presidential candidates *not* invited to appear in the debates had been discriminated against. Instead, it offered only the following cryptic statement, unaccompanied by any explanation:

> Unlike sponsorship of an appearance by a single candidate, the unavoidable impact of which is to advance the chances of that candidate's election, the debate described in the League's proposal does not involve that kind of advocacy or assistance to a campaign to which the Act's contribution limits are directed.

But surely, if sponsoring *one* candidate's appearance advances the candidate's chances for election, it follows that sponsoring *two* candidates' appearances advances one or the other (or both) of their chances for election—and does so at the expense of candidates who do not receive an invitation to appear. Many political analysts now describe the debates as the central feature of the 1976 presidential election. Excluding any candidate thus necessarily diminished that candidate's chances. Surely, then, the League of Women Voters did make "contributions" to the Ford and Carter campaigns—"contributions" well in excess of the applicable limits. Nonetheless, with the FEC's approval, the debates proceeded.

One reason that a democratic society accepts decisions made by nonelected officials (judges, agency officials, and so on) is that these decision-makers can be expected to supply the reasons for their actions. This expectation provides legitimacy for what might otherwise be essentially unaccountable power. By failing to explain itself, the commission has circumvented a major barrier that citizens have erected against the arbitrary use of power. The flat contradictions among the commission's rulings have erected a different kind of barrier—one that will deter individuals from engaging in political speech. After all, if a candidate's supporters do not know what they are allowed to do—or, especially, to say publicly—they are likely to choose being safe to being sorry.

Ignoring Judicial Decisions Interpreting the Scope of Permissible Regulation. In several decisions, all of them unanimous, federal courts have held unconstitutional the application of campaign regulation to nonpartisan, issue-oriented speech by groups such as the American Civil Liberties Union (ACLU). In one case, a three-judge panel of the U.S. District Court for the District of Columbia narrowly construed the reporting and disclosure provisions of the 1971 Federal Election Campaign Act, holding them not applicable to ACLU dis-

[4]The FEC has recently reversed itself again by proposing a new regulation to permit corporate and union contributions, in certain circumstances, for debates.

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cussions of the voting records and actions of public officials (*American Civil Liberties Union* v. *Jennings*, 1973, which the Supreme Court declined to review on grounds of mootness in *Staats* v. *ACLU*, 1975). Later, the U.S. Court of Appeals for the District of Columbia unanimously declared unconstitutional a provision of the 1974 campaign act amendments that would have forced reporting and disclosure by such groups as the ACLU and the League of Women Voters (*Buckley* v. *Valeo*, 1975). And finally, the Supreme Court in *Buckley* (1976) carefully limited the act's disclosure provision concerning independent expenditures so as to avoid deciding their constitutionality. The Court read the statute as requiring disclosure only when there was explicit advocacy of a candidate's election or defeat—as with the use of words such as "vote for" or "elect."

Undeterred by these decisions, the FEC is proceeding to regulate what the federal judiciary has ruled may not be regulated. In three separate rulings, one issued to the Sierra Club and its political committee and two issued to the United States Chamber of Commerce, the FEC has applied disclosure requirements to the following activities: the publication and distribution of voting records together with indications that the votes were "correct" or "incorrect"; the preparation, distribution, and publication of answers to questionnaires which are then made available to the general public; and the preparation of candidate "profiles" that evaluate a candidate's performance but do not explicitly advocate his election or defeat.

In addition, the commission has instituted an enforcement action against a group known as the Central Long Island Tax Reform Immediately Committee (TRIM). TRIM had published a brochure attacking the voting record of Representative Jerome A. Ambro on economic and tax legislation. Although it was highly critical of Representative Ambro's positions in Congress, the brochure contained not one word of electoral advocacy. On the contrary, it merely urged citizens to contact the member and his staff and to make their views on these matters known to him. Nonetheless, and consistent with its rulings in the Sierra Club and Chamber of Commerce cases, the commission held that there was "reason to believe" that TRIM had violated the statute. The total amount of money expended by TRIM in committing its alleged violation was $135. There is every indication that the commission takes this outbreak of free speech seriously. At last report, it had voted to institute litigation against TRIM and its chairman.

The commission is *not* required by statute to take so unremittingly hostile an attitude to independent free speech. It has done so by its own decision—and in the teeth of contrary judicial precedent. Whenever presented with a choice between more freedom of speech and less, the commission—as demonstrated by examples too numerous to catalogue in this article—consistently chooses less.

Problems with Regulating Politics

Much has been written about the unseen economic costs—passed on to consumers—generated by the need to comply with government regulations and to defend against enforcement proceedings. Where large corporations are involved, of course, the available "deep pocket" covers the costs without much visible protest, secure in the knowledge that those costs will ultimately be borne largely by others.

Politically active citizens, however, are not so likely to possess a pocket deep enough to cover the costs of litigation or agency enforcement proceedings. Typically, political activity is characterized by its spontaneity, with most of it not intended to extend beyond one election cycle. Even the national committees of the two major political parties have only recently equipped themselves to handle the numerous legal problems raised by the statute. They, and the House and Senate campaign committees of both parties, can assist their candidates and supporters in meeting the burdens of compliance only in a very limited way. The individual citizen, the third-party or independent candidate, or the primary challenger does not have even this minimum amount of potential help.

The respondent in a commission enforcement proceeding is therefore faced with a difficult choice. As we have noted, he can try to mitigate his problem by acquiescing in the commission's finding that a violation of the statute has occurred, or he can resist—in which case he involves himself in a proceeding that may be expensive and, depending on the media reaction, politically risky. Many political commit-

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tees choose the first option. While the cost to individual candidates may be quite small, the cumulative effect on the political process of numerous surrenders to the commission's authority is likely to be immense.

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But costs are not the only problem. If they were, campaign regulation might be no more onerous than the regulation of small businesses. Several characteristics differentiate politics from other activities subject to federal regulation. First, and most important, political campaigns have definite endings. Although campaigning, particularly for the presidency, has become an increasingly lengthy process, it still ends on election day. Second, no matter how much preparation a candidate may make, it will not be until the campaign itself that most of the difficult legal questions concerning campaign financing will arise and need answering. The time-consuming style of regulation typical of other federal agencies is thus a luxury that the Federal Election Commission cannot afford, except *after* a particular campaign has concluded. Third, campaigns are not highly structured corporate bureaucracies. They often engender spontaneous activity well beyond the effective control of the candidate or his staff.

These characteristics render the administrative-agency model employed in other regulatory endeavors unsuitable for the regulation of politics. Both the political actors and the commission operate in an atmosphere that precludes the calm, reflective decision-making that we like to think is appropriate for quasi-judicial bodies. Some have tried to take short cuts, but these efforts raise problems of their own.

For instance, many people, hoping to avoid incurring extensive legal fees (and waiting inordinate lengths of time for responses) before engaging in what had previously been thought to be normal political activity, have simply called the FEC on the phone or met informally with its employees. Attorneys who deal with the FEC on a regular basis know well that an informal call to the agency will produce one answer one day and a contrary answer the next. And the risks of relying on these informal contacts have now been graphically demonstrated. The Gun Owners of America (GOA) believed it had obtained FEC approval for a plan involving financial arrangements with two affiliated committees. (The details of the arrangements are too complicated to detain us here.) Then, to its surprise, the FEC charged it with a violation of the statute and levied a record fine of $11,000. In reporting to the full commission on this case, FEC General Counsel William C. Oldaker stated, "Conversations held between Respondent's counsel and Commission staff would not limit Commission enforcement action. . . ." The imposition of a record fine in this case—despite the fact that GOA was clearly attempting to comply with the statute—says something about the way this FEC does business. But the problems inherent in relying on informal opinions, along with the inappropriate length of time needed for formal opinions, say something more important about applying the regulatory commission model to the political process. It should not be done.

Nor are there any grounds for believing that the situation will improve—though the commission's defenders have been quick to argue that many of its problems were caused by circumstances surrounding its first several years. (The FEC did not come into existence until several months after the effective date of the statutes it was designed to enforce; it was immediately embroiled in litigation challenging the constitutionality of those statutes and of the commission itself; finally, the Supreme Court declared unconstitutional major portions of the substantive law, as well as the very process by which the commission was appointed. Moreover, when the FEC was recreated, further changes were made in the substance of the law, and the 1976 primaries were then well underway.) With those difficulties behind it, according to the commission's defenders, it can turn to curing the vagueness of the Federal Election Campaign Act and to constructing a comprehensive regulatory framework.

There are at least two reasons why this will not happen. Most important, the defense assumes that politicians are essentially uncreative. The evidence we have, however, shows

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them to be at least as creative as the business managers regulated by the traditional administrative agencies. Each pronouncement by the FEC will prompt some politician to devise a response, to which the commission will itself respond, and so on. The day may come when the FEC has solved all the questions that may arise, but that will be the day when politicians are no longer interested in holding elective office.

In addition, it is the purest whimsy to believe that Congress will refrain from further tinkering with the statute. In this sense, those who argue that the major problem in FEC regulation lies with Congress rather than the commission have a compelling point. Congress simply will not keep its hands off the statute. Major federal campaign-financing laws have been enacted in 1971, 1974, and 1976. In every other year since 1971 (including 1978), Congress has debated proposed changes in these laws. When the 1974 and 1976 amendments were passed, the prior amendments had not even gone through one complete election cycle so that their effect could be understood and evaluated. The election laws are obviously a matter of vital self-interest to every member of Congress. They also provide incumbents with a handy way to inflict hardship on their political opponents (while claiming to be advancing the cause of "integrity" in politics). In such circumstances, it is virtually inevitable that Congress will continue to pay extremely close attention to the Federal Election Campaign Act.

There are numerous other reasons why things will not change. The commission's own bureaucratic urge to extend the scope of its regulation comes to mind, as does the possibility that other portions of the statute will be invalidated in the courts. Politics is simply too complex and too changeable to permit the creation of a stable regulatory framework—much less one that is truly evenhanded or fair.

IN THE FACE OF the record, it is difficult to justify the commission's continuing to exist in its present form, or to deny that the wisest course would be to reexamine the underlying reason for its existence. Massive changes are needed. Without them, the FEC will become so well-established before long that it can never be seriously challenged—and another assault on free speech will have been enshrined in law. ■

Oil, Film, and Folklore

(Continued from page 20)

defined "welfare." This means maximizing budgets—which is to say, maximizing costs.

Another criticism of the market as an institution is that, while it may be more efficient than government control, it lacks a sense of justice. This could be a valid criticism inasmuch as justice is not something uniquely determined by human reason. There are as many justices as there are theologies, and the market's sense of justice may not correspond to ours. This criticism, along with my research into government-controlled markets, has led me to the following definitions:

. . . the market is an institution that creates affluence and distributes it unevenly [while] . . . the government is an institution that creates poverty and distributes it "fairly."

(1) the market is an institution that creates affluence and distributes it unevenly, and

(2) the government is an institution that creates poverty and distributes it "fairly." Obviously "fairly" must be in quotation marks, because "fair" means whatever the outcome of the political process implies. It means, for example, that I get cheap natural gas in southern Michigan while people in North Carolina, New Jersey, and Vermont go broke trying to pay their fuel bills.

To return to our analogous world of the entertainment industry, we may ask why it is fair that someone earn a fortune because he is born with flexible hips and durable vocal cords. This is the equivalent of asking why someone should earn a fortune (or anything else) because he discovers that his farm covers an oil field. To my knowledge, most people do not chastise entertainers for making a fortune rocking in the jailhouse in blue suede shoes. We accept that market outcome and fuss very little about its equity. Why is it that we place emphasis on political justice in petroleum but not in amusement? When we have answered that question, if we can, and when we have decided to allow petroleum companies and consumers the same rights we grant rock musicians and their audiences, I strongly suspect we will find the public better served. ■

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Readings
of particular interest

More on Campaign Spending

"The Economic Theory of Regulation and Public Financing of Presidential Elections" by Burton A. Abrams and Russell F. Settle, in *Journal of Political Economy*, vol. 86 (April 1978), pp. 245-257.

Did public financing alter the outcome of the 1976 presidential election? Professors Burton Abrams and Russell Settle of the University of Delaware argue that it did.

The authors begin by presenting two hypotheses on the purpose of regulation—that regulation is supplied in response to public demand to correct "inefficient or inequitable market practices" (the public-interest theory), or that it is sought by individuals, groups, or industries as a means of serving their own interests (the economic theory). They apply these two theories to the Federal Election Campaign Act Amendments of 1974 that provided for optional public financing of presidential campaigns. The public-interest theory is rejected because it attributes the inauguration of public financing to the belief that presidential campaigns are becoming more and more expensive (and increasingly susceptible to corruption), whereas "relative campaign expenditures have, for the most part, declined during the last 70 or 80 years." Turning to the economic theory, they attempt to demonstrate that it is a more reasonable explanation for this important regulatory change. Their thesis is that a Congress controlled by the Democratic party could be expected to produce a campaign-financing law that would benefit the Democratic party.

The authors point out that Republican candidates for the presidency have historically outspent Democratic candidates (except in 1912 and 1948). Their quantitative analysis shows that, holding all other factors equal, spending is positively correlated with the number of votes received. They then note, for example, that the 1974 campaign act amendments were favored in the Senate by more than 80 percent of the Democrats but only 42 percent of the Republicans and in the House by 98.6 percent of the Democrats but only 75.1 percent of the Republicans.

Inasmuch as Republican spending for presidential campaigns in the period 1900–1972 averaged 63.5 percent of total spending on these campaigns, and inasmuch as spending and the number of votes received are correlated, the public funding requirement of equal expenditures by Democratic and Republican nominees leads Abrams and Settle to conclude not only that the law was passed by Democrats to benefit Democrats, but that that goal was fulfilled. They attribute Carter's victory in 1976 to the amendments to the Federal Election Campaign Act, observing "that a Republican president signed into law legislation which seemingly led to his own party's defeat. . . ."

Predatory Pricing: A Redefinition

"Predatory Pricing: A Strategic and Welfare Analysis" by Oliver E. Williamson, in *Yale Law Journal*, December 1977, pp. 284-340.

Predatory pricing—an attempt to monopolize—is forbidden by three federal laws. Oliver E. Williamson of the University of Pennsylvania here argues that since the concept of predatory pricing involves current behavior to achieve a future purpose, it is unsuited to static economic models because they do not take into account those aspects. He notes, however, "a remarkable degree of consensus" in recent court opinions in favor of using cost to determine when pricing is predatory, probably a result of the works of Philip Areeda-Donald Turner and of Richard Posner. Both use static economic analysis (which assumes no basic changes over time in the system studied). Indeed, the Department

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of Justice has recently dropped two antitrust cases on the grounds that predatory pricing—which it defined as pricing below marginal or average variable costs (the Areeda-Turner definition)—could not be proved.

"Allegations of predatory pricing are easy to level but difficult to evaluate," Williamson writes, in part because predatory pricing may be directed at discouraging prospective rivals. Moreover, workable criteria are needed for distinguishing between predatory pricing and merely competitive pricing which will eliminate inefficiency. "An appreciation for the long-run efficiency benefits of competition is essential if the uncertainty that surrounds the law on predatory pricing is to be removed and useful rules are to be developed," says the author. Marginal cost pricing is advocated by Areeda-Turner and Posner because it promotes efficiency. Their analysis is criticized by Williamson on the grounds that, unlike his proposed rules, it fails to take account of temporary marginal cost pricing for strategic purposes.

His analysis is limited to those firms that have an incentive to exclude or eliminate existing or potential rivals (which leaves out firms in highly competitive industries), and concentrates in particular on the response of dominant firms and collusive oligopoly industries to new entrants. Williamson defines dominant firms as those with 60 percent of a market that is difficult to enter, and collusive oligopolies as a market in which firms "are able to maintain an effective concurrence of market action."

In this study, three possible rules for restraining dominant firm behavior after a new rival firm enters a market are tested. The first, the "output restriction rule" (favored by Williamson), says that after entry the dominant firm cannot increase output above the trend-adjusted pre-entry level. The "marginal cost rule" (favored by Areeda-Turner) allows the dominant firm to increase output after the entry of a new firm if the price does not fall below short-run marginal cost, and the "average cost rule" permits output to increase if the price exceeds short-run average cost. The author argues that an output rule would be easier to enforce than a marginal cost rule because of the great difficulty in measuring short-run marginal cost: indeed, "a marginal cost test would be a defendant's paradise."

The three predatory pricing rules are next evaluated for their effect on social welfare before and after entry, with the author concluding that both the short-run marginal cost and short-run average cost rules are inferior to the output restriction rule in pre-entry welfare. Total post-entry supply is identical under all three rules, which means that post-entry welfare differences turn on cost differences. The entrant's costs of supply are identical under all three rules, which means that cost differentials depend on the costs of supply for the dominant firm. These turn out to be less for the output restriction rule than for the others. Williamson also argues that it is easier for potential entrants to predict dominant firm behavior with the output restriction rule than with the cost-based rules, because the latter allow greater latitude and, therefore, greater uncertainty.

There may also be predatory pricing among established rivals. Price-cutting can occur (1) in loose oligopolies, (2) in industries still in the early stages of development, and (3) by firms attempting to enter a new market, and in *each* of these situations, these are special problems. For the first, output restriction rules are irrelevant because firms have little incentive to use strategic behavior, so Williamson suggests an average total cost test, except for the special case of declining industries where the Areeda-Turner test (an average variable cost test) is suitable. (This is the "only case for which the Areeda and Turner tests and those proposed here" agree.) For the second, he proposes a double test—that the price-cutting firm be required to show that its prices cover prospective costs for the short-run future and that, in order to bring a case, the competing firm demonstate its ability to achieve the cost levels of the price-cutting firm. For the third ("promotional pricing"), Williamson suggests a very limited short-run exemption from predatory pricing rules, because new entrants can in fact be engaged in predatory pricing.

The article concludes with a critique of the predatory pricing rules proposed by Areeda and Turner. Williamson points out that their rules do not distinguish between predatory pricing in response to new entry and among established firms. Further, the rules rely on marginal cost pricing tests, admittedly difficult to estimate. He urges, instead, his output restriction rules for dominant firms facing new entry. Such firms should be governed over the short- and

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intermediate-run by the "business as usual" rule that quantity produced by the dominant firm after new entry cannot exceed the trend-adjusted pre-entry quantity and that in the long run (after the rule has expired) prices must recover full (total) costs. Williamson argues that his "output restriction rule provides a practicable way to sort out meritorious from protectionist claims of predatory behavior."

The FTC: Competition and Stability

Economic Regulation and the Public Interest: The Federal Trade Commission in Theory and Practice by Alan Stone (Ithaca, N.Y.: Cornell University Press, 1977), 314 pp.

Professor Alan Stone, a political scientist at the University of Houston, begins this study of the Federal Trade Commission with the thesis that the agency's actions, as well as its successes and failures, stem mainly from "a central contradiction" in the conduct of both business and government under capitalism—"the fundamental contradiction between stability and competition." Because of this conflict, the impact of economic regulation is often nullified or, if the regulation is strictly enforced, its cost to the public is often too great.

In Part One, Stone (who served as an attorney with the FTC from 1960 to 1968) reviews the legislative history of each statute administered by the FTC and considers how effectively these statutes have been enforced. Beginning with the Federal Trade Commission Act and the Clayton Antitrust Act, he uses case studies to illustrate the contradictory content of the FTC Act's proscription against "unfair" competition and to trace the way the agency has both promoted and restricted competition in entering its "cease and desist" orders against individual transgressors. In Stone's view, the cease and desist order itself is an ineffective enforcement tool, reflecting as it does "an uneasy compromise" between the need for stability and the need to compete. Its use has led to pressures for more efficient sanctions and, therefore, to increased resistance by business. The FTC, says Stone, will always be subject to criticism so long as its major sanction continues to be the cease and desist order, under which "a transgressor is entitled to a free bite of the apple before the courts can impose any meaningful monetary penalty; so deterrence is minimal." Nor is he optimistic about the efficacy of recent enforcement powers granted to the FTC.

In Part Two, Stone continues his consideration of how the FTC has both promoted and restricted competition, focusing on issues dealing with exclusionary and collusive practices. He examines two periods—1956–1964 and 1973–1975—the first having been described by agency critics as typical of the FTC's bad performance, the second as a time when the agency sought to reform itself and became more public interest oriented. In both periods, says Stone, the cases reflect (1) "the fundamental contradiction between competition and stability inherent in the statute" and (2) the FTC's dependence, in most cases, upon the business community for information about possible violations.

The most important amendment to the Clayton Act was the Robinson-Patman Act of 1936, which, says Stone, "stands unambiguously on the side of stability and against vigorous competition." The fact that the FTC, which tried hard for many years to enforce Robinson-Patman, has—because of considerable criticism—virtually ceased to enforce it prompts Stone to conclude two things. The first is that the statute's impact on the U.S. economy has been almost nil. (This is also the conclusion of his examination of FTC antimerger policy.) The second is that, if the statute is to be abrogated, this should not be done by "administrative whim" and that the future will probably bring another period of vigorous enforcement.

The FTC's growing role in the area of consumer protection is detailed in Part Three. Included are analyses of the way the commission uses its original mandate to prevent unfair competition in fighting deceptive advertising and of the Wheeler-Lea Act of 1938 (which applied criminal provisions to the advertising of drugs that could lead to bodily harm). Other sections deal with the four labeling acts: The Wool Act of 1939, the Fur Act of 1951, the Flammable Fabrics Act of 1953, and the Fiber Act of 1958. Characterizing these statutes as attempts to lessen competition by imposing standards that would help consumers, Stone argues that they have also aided producers. The FTC's administration of all but the Flammable Fabrics Act

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has had little impact on consumers' buying habits, and the same is generally true of three newer laws passed in response to the growing consumer movement: the Fair Packaging Act, the Consumer Credit Protection Act, and the Magnuson-Moss Warranty FTC Improvement Act. These laws marginally aid consumers, he says, but fall short of consumerists' goals. Moreover, each "inhibits unacceptable forms of competition, yet is sufficiently flexible to permit some competition to remain in the problem area." This leads Stone to wonder, in pondering the possibility of there being a defect in the nature of regulation, whether the notion that regulation will help consumers is equivalent, in Milton Friedman's image, "to an expectation that cats will bark."

The FTC has failed to satisfy anyone, says Stone, the reasons for this being built-in delay, inadequate money expended, the use of the private litigation system as a model, and ineffective sanctions. Moreover, on the whole, regulation often leads to market distortions very costly to the consumer. Thus, this kind of regulation, although a response to serious problems created by the market, is not and cannot be an "effective instrument for promotion of public values." This leads Stone to conclude that public ownership of industry within a democratic framework deserves serious study.

The Value of a Life

"How Much Should We Spend to Save a Life?" by Steven Rhoads, in *The Public Interest*, Spring 1978, pp. 74-92.

Professor Steven Rhoads of the University of Virginia asks, "Can't we think sensibly about lifesaving programs without trying to put a dollar value on human life?" The article first surveys benefit-cost approaches to valuing life, concentrating on "willingness-to-pay" (WTP) and "discounted-future-earnings" (DFE) and their applications. "The victory of the DFE approach within the government has been . . . complete." This approach means that one starts with the average age at which death or disease occurs and calculates what future income would have been, given a normal life term. This figure is then discounted (a dollar today is worth more than a future dollar because the former can be invested), and the result is the value of life for the average member of the group in question. The Department of Health, Education and Welfare, the Federal Aviation Administration, and the Office of Science and Technology have used this straight DFE method. Among the problems of DFE are the facts that it yields a much higher figure for men's lives than for women's (men earn so much more) and that it seems to represent a "crude materialism" devoid of such considerations as pain and grief.

The WTP approach tries to determine preferences based on the willingness of individuals to pay for reduction in risk. WTP is calculated by obtaining a figure that represents the amount those who are affected by a government program are willing to pay for this benefit. The aggregate figure is then divided by the number of lives saved, and this amount is assumed to be what could justifiably be spent to save a life under the program. The difficulty lies, Rhoads points out, in making the original calculation. Three serious studies have used polling or job market decisions as their basis, with conflicting results. Still when these results are compared with the value of life figures obtained by DFE, it appears that the latter (ranging from $100,000 to over $400,000) are much too low.

Are the principles of benefit-cost analysis a "sufficient guide for public policy on lifesaving programs?" A different approach is to ask, Who should benefit from scarce exotic lifesaving therapy? The answer has been either that preference should be given to the most deserving (defined to consider age, number of dependents, and future potential, among other criteria) or that all should be treated equally. Rhoads urges the use of economic analysis along with "political judgment," which includes a willingness to distinguish "between things that some people desire and things that are truly important."

The article concludes with a prediction that we will never see value-of-life issues debated openly as are other kinds of public policy issues. This is a good thing, in Rhoads's opinion, because society should never publicly place a "value on human life." Rather, legislators should affirm the pricelessness of human life, by saving a whole category of people (such as those suffering from kidney failure), because

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those values that depend on the sanctity of life are constantly being undermined.

The Other Side of Advertising

The Political Economy of Advertising, edited by David G. Tuerck (Washington, D.C.: American Enterprise Institute, 1978), 217 pp.

"Political" or "public" advertising can refer to advertising by governments and political parties. It can also refer to advertising by private organizations in response to government requirements and incentives or for the purpose of deterring additional government regulation. This volume brings together eight papers from an AEI conference that examined the growing political role of advertising in public policy.

—Charles Clotfelter of the University of Maryland provides a classification of public advertising, describes the functions performed by such advertising, and estimates its total cost at $650 million in 1974.

—Murray L. Weidenbaum and Linda L. Rockwood of Washington University (St. Louis) take a broader view of public advertising, one that includes private-sector advertising in response to government promotion or subsidy. They examine the effects on private decision-making of a number of government activities, specifically, government procurement programs, revenue-sharing requirements, election campaign subsidies, affirmative action policies, postal subsidies, and tax laws. The "carrot and stick" nature of much government funding of the private sector may have, they conclude, adverse effects on the freedom to disseminate information.

—David Tuerck, editor of the volume and former director of AEI's Center for Research on Advertising, explores existing economic theories to see if they can identify which advertisements should be provided by government and which should be regulated. Tuerck asks whether economic theory can provide a set of standards for this purpose, concludes that such a use of economic theory is inappropriate, and cautions against attempting to apply it to public policy areas it is ill-equipped to consider.

—Richard Wagner of Virginia Polytechnic Institute analyzes political advertising according to two theories of democratic government. One theory, which stresses similarities between government and the market, views political advertising (like private-sector advertising) as a cost-effective means of disseminating information about candidates and programs (products and services) so that voters (consumers) can choose intelligently. The other, which stresses the monopolistic nature of democratic government, views political advertising as a means of promoting voter approval of the current majority and thus further expanding the public sector. Wagner notes that publicly supported political advertising fits in with the second theory.

—Allen M. Wyse and David G. Davies of Duke University analyze the function of advertising by government bureaucracies. The bureaucrat can attempt to influence the "consumer-voter's" expectations by providing information about the bureaucratic policy. Wyse and Davies find that bureaucracies produce information beyond the point at which marginal benefits equal marginal costs. The availability of free "public service" media time to the bureaucrat distorts relative prices in such a way as to discourage the use of "scientific/product" information and to encourage the use of less reliable "exposure" information.

—Robert J. Staaf of VPI examines the subsidies and restrictions that have been applied to political campaign financing in the post-Watergate era, and analyzes campaign contributions as payments for political favors. Agreeing with Wagner that the role of information is fundamentally different in political decision-making from what it is in commercial decision-making, he notes that the voter, unlike the consumer, "receives no benefit from possessing unique information since decisions are not made at the margin, but rather according to majority rule." In Staaf's view, campaign financing laws have replaced individual decisions with collective decisions and therefore represent a loss of individual freedom.

—Albert J. Martin of Florida International University discusses the cost-effectiveness of public advertising for recruiting military personnel. For this purpose he describes a Defense Department study that finds paid radio advertising likely to be useful in recruitment efforts.

—James H. S. Pierson, an economist at AT&T, analyzes sales-related and institutional

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advertising by public utilities, showing how public utility advertising is affected by regulators' decisions to disallow advertising expenditures for rate-making purposes. He concludes by raising some of the difficult questions about the role of regulation in changing or maintaining public attitudes: for example, should the public pay (via utility rates) for advertising designed to alter its own views? Should regulators be making these kinds of decisions?

Does Freight Rate Regulation Really Matter?

"Allocation in Surface Freight Transportation: Does Rate Regulation Matter?" by Richard C. Levin, in *Bell Journal of Economics*, vol. 9 (Spring 1978), pp. 18-45.

The prevailing view of economists that rate deregulation would improve surface freight transportation is reflected in both the Railroad Revitalization Reform Act of 1976 and the administration's transportation policy. But Yale economist Richard Levin doubts that the savings would be as large as claimed. He argues here that, for two reasons, economists seriously overestimate social costs of freight regulation (including the misallocation of traffic from rail to truck). In making their calculations they concentrate on differences in shipment size and average transit time, and they assume "that all shippers have identical preferences" for the various features of freight transport.

Levin constructs a model to measure the effects of certain characteristics of shippers, shipments, and kinds of transport chosen on the market shares of truck, boxcar, and piggyback (trailer on flatcar) transport. His study is limited to shipments of manufactured commodities and uses data for forty-two such commodities.

Taking reported revenues for boxcar and piggyback traffic, Levin calculates the average rates for both and, since equivalent data are not available for trucks, he assumes that truck rates are competitive. Calculations of transit time are based on a 1968 study which uses Defense Department data showing that truck transport is faster up to a distance of 915 miles, piggyback faster than truck beyond 915 miles, and rail faster than truck beyond 2,430 miles. Though the variation in transport time is less for trucks than for rail, the differences are not so great as had previously been thought. Finally, in order to compute the welfare loss from rate regulation, it is necessary to use the ICC cost formulas (although they have been criticized for employing inappropriate techniques to divide railroad costs into fixed and variable components).

Based on these data, Levin finds that a 2 to 7 percent increase in market share results for any of the three kinds of transport when transit time is reduced by one day. This compares to the increase in market share of only 2.5 to 3.5 percent that results from a drop in freight rates of $1.00/ton. Levin concludes that time is considerably more important to shippers than price. Other advantages of truck service not measured in this study (including such things as a better loss-and-damage record, faster pick-up, and greater flexibility in meeting shippers' needs) are large enough so that truck rates could be 12 percent higher than boxcar rates before trucks and boxcars would split the market evenly.

One problem with his model, Professor Levin notes, is that it assumes, contrary to fact, that shipment size is determined prior to a shipper's choosing whether to use rail, piggyback, or truck. But the data are not available to measure how the choice of transport influences shipment size.

With all this in hand, Levin substitutes marginal costs for current boxcar and piggyback rates in the regression equations of his model of shippers' preferences, in order to calculate the loss to society stemming from regulation of surface freight rates. This yields the market share that would correspond to an efficient allocation in each transport market.

For the commodities in his sample, his estimates of the overall cost of rate regulation range from 0.3 to 0.75 percent of total freight revenue—which, assuming these commodities are representative, works out to $53 million to $135 million for 1972. This figure compares with widely cited previous estimates by other economists ranging from $1 to $3 billion.

Professor Levin points out that his results clearly indicate that the benefits to be expected from deregulation of freight rates are small.

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But he suggests some reasons for caution before concluding that rate deregulation is undesirable. For example, his estimates apply only to manufactured products, and the case may be quite different for agricultural products. Also the indirect social costs of rate regulation may be much greater than the costs he measures. Therefore, if rate regulation leads to excess service competition and "limits the diffusion of new low cost technology," it causes higher transportation costs.

Levin urges that policy-makers, instead of expecting the largest social costs to disappear with rate deregulation, should adopt measures aimed directly at cost reduction—eliminating operating restrictions and allowing mergers. He expresses the hope that this study will show other economists that they should not focus narrowly on rate distortion as the "principal ailment of the transportation system."

ICC Regulation of Household Movers

"The Monopoly Value of Household-Goods Carrier Operating Certificates" by Denis A. Breen, in *Journal of Law and Economics*, April 1977, pp. 153-185.

Denis A. Breen of Washington State University applies the "producer-protection" theory of regulation to the household-goods carrier industry, in order to determine the value to the carriers of ICC regulation. According to this theory, if regulation creates monopoly profits by protecting producers from competition, those profits should be reflected in the sale value of operating certificates. (For this argument as applied generally to common-carrier trucking, see the article by Milton Kafoglis in *Regulation*, September/October 1977.)

In 1971 the household-goods moving industry included 2,400 carriers involved in interstate commerce and therefore subject to ICC regulation. Twenty-five nationwide movers accounted for about two-thirds of the industry's revenues of $910 million. The rest of the industry was composed of 120 regional movers and about 2,200 small local movers.

One outstanding characteristic of the market behavior of the industry is its pricing policy. Almost all firms are members of either the Household Goods Carriers Bureau or the Movers and Warehousemen's Association of America. These rate bureaus, operating with antitrust immunity, publish moving rates for their members, the result being a complete uniformity of rates in any given market area.

Since 1935 the trucking industry, including the household-goods movers, has been subject to regulation by the ICC. In addition to controlling entry into the industry, the ICC sets minimum rates ("the commission workload is dominated by minimum as opposed to maximum rates cases"), prohibits "discriminatory" rates, and often suspends rate cuts pending ICC review.

In spite of the generally protective nature of ICC regulation, certain recent developments limit the extent of monopoly profits in the household-goods carriers industry. For example, consumer pressure has led to reforms such as "interlining" (transferring shipments from one carrier to another, a practice that allows movers with limited operating authority to compete with those holding long-haul authority) and prohibition of peak and off-peak pricing (movers must charge the same rate the year round, rather than charging higher rates for busier periods). Nevertheless, Breen argues, the effect of ICC regulation is to create monopoly gains for the industry and these gains are "capitalized into the market value of transferable operating certificates."

Using actual sales prices between 1970 and 1973 for seventy-one radial certificates (which authorize operations from a fixed base or hub to points within a prescribed area), Professor Breen constructs a model, using multiple regression analysis, to estimate the sale value of similar certificates. His results show that certificate prices are positively related to population and the length of haul, and negatively related to competition. In other words, much of the extreme variation in value among smaller radial certificates (a range of about $500 to $26,000) is due to these three factors.

On the theory that the bulk of the monopoly profits that regulation creates for household movers would be reflected in the value of the largest certificates—nationwide nonradial (operating rights between any two points in a prescribed area)—Breen estimates the sale value of such certificates. Using the amount

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spent by carriers to acquire enough existing certificates to achieve nationwide status, he arrives at a preliminary figure of $361,857 for the average sum actually paid by a sample of seven nationwide carriers. Because none of the carriers has ever purchased complete nonradial rights to operate in the continental United States, this figure understates the true value. Breen adjusts for this by simulating the purchase of authority to operate in the Western states (more expensive, and in most cases, incomplete in the existing authority of the seven), arriving at a figure of $728,857. This is then assumed to be the value of each of the fourteen nationwide nonradial certificates that actually authorize service in all forty-eight states.

Based on these figures, the total monopoly value for the industry would be $39.4 million (the fourteen nonradial plus the 2,807 other certificates). But a further correction is necessary because, although the fourteen nationwide movers alone account for 52 percent of industry revenue, in these computations they only represent 26.9 percent of the monopoly value. The corrected estimate of the monopoly value of operating certificates for the entire industry is thus $60.8 million.

Breen recommends that "serious consideration" be given to deregulating household-goods carriers. Abolishing entry controls, rate regulations, and antitrust immunity would probably result in lower rates (because of increased competition or potential entry into the industry), while ending discriminatory rates and eliminating inefficient firms.

Public Disclosure at the Fed

Federal Reserve Policies and Public Disclosure edited by Richard D. Erb (Washington, D.C.: American Enterprise Institute, 1978), 108 pp.

In February 1977 AEI sponsored a conference on the impact of more open decision-making within the Federal Reserve System. This volume includes three conference papers (plus commentaries) covering the effects of public policy disclosure on (1) domestic monetary policy, (2) international monetary policy, and (3) bank supervision and regulation. In addition, an introduction by editor Richard Erb, AEI resident fellow, reviews the effect upon the Federal Reserve System's traditional independence of "government in the sunshine" and "freedom of information" legislation, coupled with more aggressive congressional oversight.

In Part One, Benjamin M. Friedman of Harvard University argues that the economic arguments for and against greater disclosure of the Open Market Committee's monetary policy deliberations "are relatively weak on either side, especially if the Committee were to be permitted some limited discretion to withhold potentially damaging specific items of information." The disclosure issue is primarily political, he says, and, because it is, revelations about the committee's objectives, forecasts, and fiscal policy views would probably fuel public debate and greatly increase the Federal Reserve's political vulnerability. In comments on the paper, Sherman J. Maisel, a former governor of the Federal Reserve, suggests that public disclosure of the Open Market Committee's discussions would produce weaker committee decisions and greater rigidity within the system; Robert Z. Aliber of the University of Chicago, on the other hand, believes that the case for complete disclosure on monetary policy is "compelling."

In Part Two, economist A. James Meigs at Claremont Men's College points out that the boundary between domestic and international monetary policy is unclear because responsibility for the latter is distributed among so many diverse government agencies and is so poorly defined. Meigs argues for an "announced steady-money-growth rule" along with floating exchange rates in order to reduce uncertainty about domestic monetary policies and thereby help to stabilize foreign exchange rates. The problem of stabilizing exchange rates, he says, "is that market expectations are strongly influenced by changes in the U.S. money supply." Commenting on Meigs's paper, William Poole of Brown University and Roger E. Shields, deputy assistant secretary of the Treasury for research, argue that Meigs did not draw an adequate distinction between disclosure per se and other policies designed to produce exchange rate stability.

In Part Three, Neil B. Murphy of the University of Maine notes that, as a result of requirements for increased disclosure by individual banks, "there is not much information

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about a bank's financial condition . . . that is not currently available." He reports that the Securities and Exchange Commission has now become a major bank regulator through monitoring the accounting methods employed, but that empirical studies have shown little adverse effect of disclosure thus far. In their comments, Lewis Mandell of the Comptroller of the Currency's Analysis Office and Dudley D. Johnson, vice president of Citibank, agree that one unstated reason for increased reporting requirements is the desire to attain social goals.

In the opinion of the book's editor, Richard Erb, Murphy's paper and Mandell's and Johnson's commentaries suggest that as a result of greater disclosure of individual bank data, the investment community is better able to evaluate the performance of individual banks and thus to discipline errant bank managements by influencing stock values. Therefore, we may eventually discover that one consequence of greater disclosure will be a reduction in the supervisory requirements of the bank regulators.

Burdening the Democratic Process

Proposals for Government Credit Allocation by Leland B. Yeager, with a foreword by Yale Brozen (Washington, D.C.: American Enterprise Institute, 1977), 75 pp.

Yale Brozen of the University of Chicago points out in his foreword to this study that federal borrowing and federally assisted borrowing claim a growing proportion of available credit —36 percent today compared to 13 percent in 1960. Increased federal activity in the credit markets has made funds scarcer for other borrowers, forcing up interest rates and leading to demands for more government assistance. "Thus, credit-allocation programs beget more such programs."

In this analysis, one of a series of AEI evaluative studies in economic policy, Professor Leland Yeager of the University of Virginia examines the proposals and arguments for selective credit controls, the effectiveness of the controls, and their costs (potential and actual) to the U.S. economic system. He concludes that enactment of government credit allocation programs to the extent favored by their proponents would place a burden on the democratic process that would threaten to overwhelm it.

As credit tightens and interest rates rise, pressures increase for government allocation of credit to assist what are perceived to be high-priority social programs affecting small business, farming, housing, and state and local governments. According to Yeager, there is as yet "no systematic and coherent case" for the efficaciousness of credit controls as an instrument of public policy. Nevertheless, he points out, the ambitious intent of such proposals is clear: "to steer credit toward some uses and users and away from others by issuing commands and prohibitions or offering positive and negative inducements to lenders and perhaps to borrowers also."

In appraising this central idea, Yeager criticizes such arguments for controls as their use to eliminate discrimination against the poor, to help perfect the free market system of credit allocation, to further consumption of "merit wants," or to help redistribute income. Noting that credit controls have proliferated in part through the extensive use of various loopholes to circumvent them, he argues that the evasion of "negative" controls is assisted by the "fungibility" of money and credit. This enables individuals and corporations to shift funds ostensibly borrowed for one purpose to a completely different purpose. Loopholes, in turn, lead to additional controls, causing costs to mount in an effort to force compliance. Selective credit controls, therefore, "tend to undercut the profit orientation and market character of financial markets and of the whole economic system. . . . They nudge the economy in the direction of central planning."

Yeager believes that the ultimate consequences of this would be to overburden the democratic process, "for effective economic planning cannot be accomplished democratically." Furthermore, increased government credit allocation would foster a vast multiplication of government activities that would defy monitoring either by the people's elected representatives or by the people themselves. Among the dangers he foresees are broader grounds for lawsuits and a wider scope for court decisions creating unexpected legal precedents.

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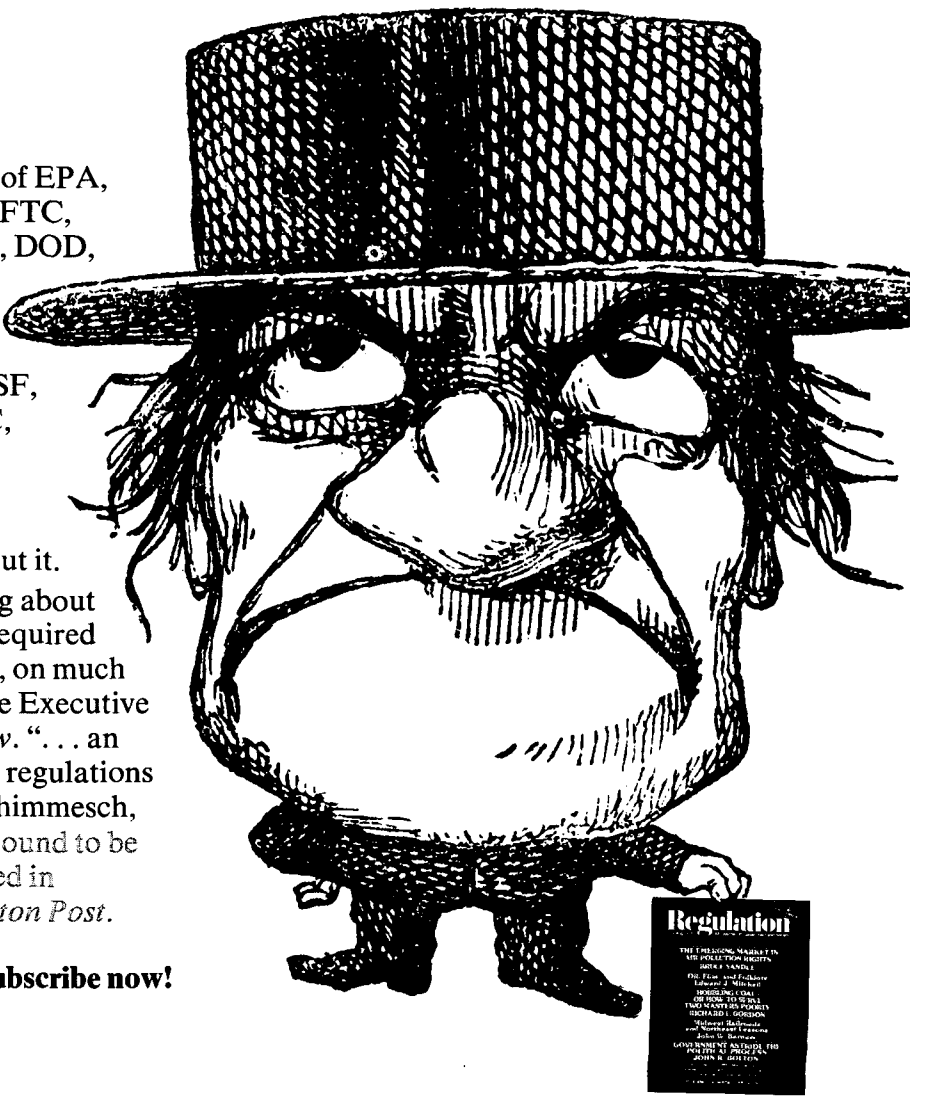

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